

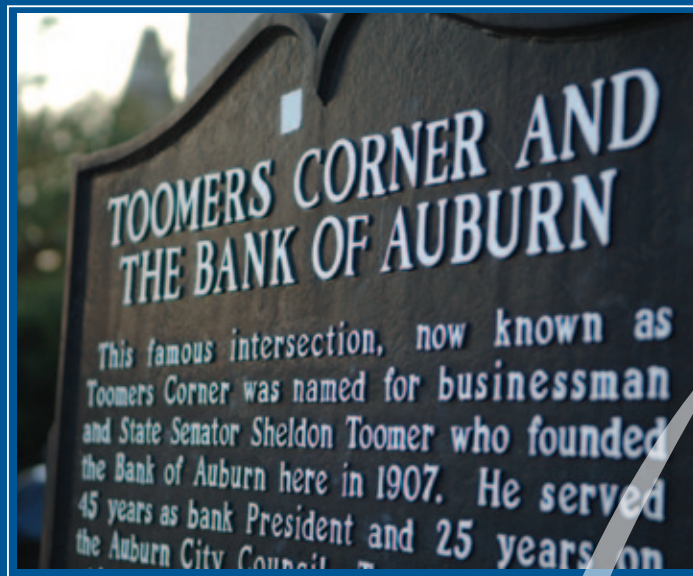
# A WINNING STRATEGY



2010 ANNUAL REPORT



AUBURN NATIONAL BANCORPORATION, INC.



For almost 60 years, AuburnBank and Toomers Corner grew side by side, sharing the roots of our community. A winning strategy undergirded the success of the bank while a community celebrated victories among the oaks across the street. The bank remains in sight of the famous street corner, which bears the name of a founding member of AuburnBank, and both continue to serve the community on which they were built.

AUBURN NATIONAL BANCORPORATION, INC.  
2010 ANNUAL REPORT

A WINNING STRATEGY



AUBURNBANK

SINCE 1907  
YOUR PARTNER, YOUR NEIGHBOR,  
YOUR FRIEND

# CORPORATE PROFILE

Auburn National Bancorporation, Inc., is a one-bank holding company established in 1984, and incorporated under the laws of the State of Delaware. Its total assets were \$764 million as of December 31, 2010. Since its inception, Auburn National Bancorporation has wholly owned AuburnBank.

As the effects of a national recession continued to batter East Alabama in 2010, AuburnBank focused on a winning strategy of sound banking practices to mark a year of strong financial performance. In spite of an unrelenting weak housing market and less than optimal credit conditions, AuburnBank significantly exceeded last year's bottom line and continued to strengthen its reserves. For the fifth consecutive year, AuburnBank was named one of the top 200 community banks in America by *U.S. Banker* magazine, one of many external measures of the bank's strength.

AuburnBank's mortgage lending area continued its strong contributions to 2010 earnings, a bright spot in what is a troubled market in many parts of the country. Although refinancing of existing home loans led the way in mortgage earnings, a steady stream of conventional loans for single-family homes added to our bottom line.

AuburnBank's profitability showed a marked improvement over the previous year, with \$5.3 million in net earnings compared to \$2.4 million in 2009. In addition, we reported \$27.7 million growth in deposits and provided increased dividend payments to shareholders for the tenth consecutive year. By any measure, AuburnBank is a well-capitalized bank with sound reserves and significant liquidity to meet both short and long-term cash needs. We continue to observe the highest standards in our underwriting process and we will continue our efforts to reduce our nonperforming assets in 2011.

Beyond the improvements of the bank's performance, we also took steps in 2010 to evaluate expansion opportunities that will likely manifest themselves in 2011.

Community plays a vital role in AuburnBank's winning strategy. We are proud of our involvement in many local charities, special events, education, and opportunities for service, both at a corporate level and among individual employees. For decades the bank has enjoyed a synergistic relationship among its customers, the University, and the communities we serve. In spite of continued economic uncertainties in 2011, one thing remains quite certain: We will provide for your financial needs and are delighted to be able to serve our customers and shareholders from a position of financial strength.

AuburnBank provides a wide range of services, including traditional checking and savings accounts, loans, and internet banking. These services are available to individuals, families, and businesses, and are offered at our many convenient locations.

In addition to its principal office, AuburnBank operates full-service branches in Opelika, Hurtsboro, and Notasulga, Alabama, as well as the new Bent Creek branch in Auburn. In-store branches are located in Auburn and Tiger Town Kroger supermarkets as well as Wal-Mart SuperCenter stores in Auburn, Opelika, and Phenix City, Alabama. Mortgage loan offices are also located in Phenix City, Valley, and Mountain Brook, Alabama. An extensive network of automated teller machines is operated throughout East Alabama. In addition, AuburnBank offers full financial consulting through a partnership with Bert Harris and Investment Professionals, Inc. (IPI), specializing in retirement planning, college saving, and estate planning.

AuburnBank has been operating continuously since 1907 when it was established as the first financial institution in Auburn, Alabama. Auburn National Bancorporation's initial public offering was held in 1995. The common stock is traded on the NASDAQ Global Market under the symbol "AUBN."



Robert W. Dumas  
President and CEO  
AuburnBank







## TO OUR SHAREHOLDERS AND FRIENDS


In spite of a third year of less than favorable economic conditions, AuburnBank continued to produce positive results in 2010. Thanks to our management team, dedicated employees, and a great deal of hard work, AuburnBank has found a winning approach to combat one of the worst economic downturns in years.

In the face of a weak economy, AuburnBank has performed well. In 2010, our net earnings were \$5.3 million, or \$1.47 per share, compared to \$2.4 million, or \$0.66 per share in 2009. Highlights of 2010 included a stable loan portfolio, paying a dividend of \$0.78 per share, and producing net interest income (tax-equivalent) of \$20.6 million, an increase of one percent. Moreover, we strengthened our loan loss reserve to 2.05 percent of total loans in 2010, compared to 1.73 percent in 2009.

The relationship between our bank and our communities sets AuburnBank apart from the competition. I am always proud to report that our employees continue to participate in a wide range of charitable and civic activities, each one contributing to the quality of life in East Alabama. In addition, I cannot overstate how much we appreciate the relationships we have with both commercial and consumer customers, relationships that play a major role in our good financial results.

This year, the continued uncertainty in financial markets will present further challenges. We have quickly and decisively addressed unfavorable credit issues and made further provision for loan loss that will enable us to continue our plans to expand our branch network and grow our service area. The winning strategies that have been our guide since 1907 still serve us well.

Your confidence in us as a shareholder continues to inspire our team to live up to the highest standards as the stewards of your ownership in the bank. We deeply appreciate your support and encouragement.

A handwritten signature in dark ink, appearing to read "E.L. Spencer, Jr.", with a stylized, cursive script.

E.L. Spencer, Jr.  
Chairman, Board of Directors  
AuburnBank and ANBC

# A W I N N I N G S T R A T E G Y



**Shel Toomer 1912-1957**



**Emil Wright 1957-1969**



**Bobby Blake 1969-1981**







**Clark Hudson 1981-1983**

**William Walker 1984-1990**

## STEADFAST LEADERSHIP.

**I**n the shadows of Toomer's Corner, former presidents of AuburnBank shared roots with tradition, developing a common vision which has led the Auburn community and financial services industry for more than 100 years. Shel Toomer guided the bank, community and Auburn University through two world wars and the Great Depression. Bobby Blake embraced the emerging ATM era and led the community through the historic Kopper Kettle explosion. Clark Hudson ushered in unprecedented growth to East Alabama while William Walker, a third-generation banker, embraced technology and promoted extensive customer service by actively serving the Auburn Chamber of Commerce, The Industrial Development Board, United Way, etc. When farmers had nothing in the 1920s, when the community and university shuddered through the Great Depression, when GIs returned home from World War II, Auburn Bank remained steadfast by honoring the slogan, "Since 1907, your partner, your neighbor, your friend."



## FISCAL RESPONSIBILITY. COMMUNITY INVOLVEMENT. HIGHEST LEVEL OF CUSTOMER SERVICE.

We understand excellence through perseverance. We've been there and have celebrated the thrill of victory, like a championship season, with our community.

The hallmarks of Auburn Bank are these components of a winning strategy. A way of doing business that elevates us to a peer group of one — the best.

We've established business practices with a vision for the economic needs of East Alabama, both personally and commercially, with fiscal responsibility to shareholders. Our approach to doing business allows us to participate and support a wide array of charities, civic groups, educational organizations, etc. as a means of transcending the basic role of a community bank. We also place customers at the highest priority, taking extraordinary measures to exceed expectations.

Above, from top: Mortgage loan originator John Reese offers the bank's most prized product to a customer—excellent service. On behalf of the United Way, bank officer Christy Fogle reads to a class at the Auburn Daycare Center. Volunteers for the East Alabama Chapter of the National Alliance for the Mentally Ill use the downtown bank parking lot as a fundraiser during Auburn University football Saturdays. AuburnBank president and CEO, Robert W. Dumas, accepts the gavel as president of the Alabama Bankers Association.





# NATIONAL RANKING. LOCAL RECOGNITION.

These fundamental strategies result in national championships...national recognition. For example, AuburnBank was honored to have been named as one of *U.S. Banker's* Top 200 Community Banks for the fifth consecutive year. *Seeking Alpha*, a financial news Web site that provides information and analysis on investing, recognized AuburnBank stock's consistent performance over the past decade. And, locally, the readers of the Opelika-Auburn News once again voted AuburnBank recipient of the Readers' Choice Award, recognizing it as the best bank among 16 local competitors.



**SNAPSHOT**  
**The New Benchmark**  
TOP 200 COMMUNITY BANKS AND THRIFTS AS OF DEC. 31, RANKED BY 3-YEAR AVERAGE ROE

When it comes to return on equity, 30 is the new 11. A couple of years ago, a three-year average return on equity of 10 percent would have been seen as subpar, while 11 percent would have been just good enough to earn a bank a spot in *U.S. Banker's* annual ranking of the top 200 community banks. By today's standards, though, a 30 percent ROE is more than respectable—nearly half the field in this year's top 200 was in the single digits—and banks with ROEs of 10 percent or better are rare.

The biggest star of all these days is Hibernia Corporation. According to data compiled by S&P, Financial LLC, the parent of Heritage State Bank ranked as the top performer among those with less than \$2 billion of assets for the second consecutive year. Only one other company, Seafirst Bancorp., has ranked among the top 10 for two years running.

Once again, Pecos Valley had the most banks on the list, with 11—not bad for a state many consider to be overbanked. Still, in this economy, a bank's fortunes can turn in a hurry. Two banks that ranked among the top 50 last year have since failed, and unless the economy stages a spectacular recovery, it's a good bet that some on the current top 200 list won't be around this time next year. —Alex Kline

Rank	Company Name (Ticker)	City, State	Total Assets (\$M)	Market Value* (\$M)	Share Price* (\$)	2009 ROAE (%)	3-Yr Avg. ROAE (%)	Net Interest Margin (%)	Net Income (\$000)	Non-Interest Income (\$000)	ROAA (%)	Efficiency Ratio (%)
113	Trinity Bank N.A. (TNYT)	Fort Worth, TX	151.23	26.76	24.00	10.62	10.09	3.02	1,636	400	1.12	53.18
114	ASB Financial Corp. (ASBN)	Portsmouth, OH	219.07	18.58	11.65	12.74	10.06	3.81	2,373	1,103	1.09	54.80
115	Auburn National Bancorp. Inc. (AUBN)	Auburn, AL	773.38	67.03	18.40	4.23	9.97	2.78	2,404	6,771	0.31	52.29
116	Washington Banking Co. (WBOC)	Oak Harbor, WA	1,045.87	188.07	12.29	5.57	9.97	4.63	6,214	7,661	0.66	55.05
117	Citizens Bancorp. (CZBC)	Corvallis, OR	403.52	54.88	11.76	7.19	9.96	5.39	3,658	2,558	0.90	58.19
118	F.S. Bancorp. (FXLG)	Lafayette, IN	877.99	55.69	50.00	9.39	9.96	4.15	3,992	3,904	0.87	65.94



## AUBURNBANK BOARD OF DIRECTORS



2010 Board of Directors

Left to Right: David E. Housel, Robert W. Dumas, Edward Lee Spencer, III, Anne M. May, Dr. Emil F. Wright, Jr., E. L. Spencer, Jr., Terry W. Andrus, J. E. Evans, C. Wayne Alderman, J. Tutt Barrett, and William F. Ham, Jr.

## AUBURN NATIONAL BANCORPORATION, INC. AND AUBURNBANK

### BOARD OF DIRECTORS

Terry W. Andrus  
President, East Alabama  
Medical Center

C. Wayne Alderman  
Secretary to ANBC  
Dean of Enrollment Services and  
former Dean, College of Business,  
Auburn University

J. Tutt Barrett  
Attorney, Dean and Barrett

Robert W. Dumas  
President & CEO, AuburnBank

J.E. Evans  
Owner, Evans Realty

William F. Ham, Jr.  
Mayor, City of Auburn &  
Owner, Varsity Enterprises

David E. Housel  
Director of Athletics Emeritus,  
Auburn University

Anne M. May  
Partner, Machen, McChesney  
& Chastain, CPAs

E.L. Spencer, Jr.  
Chairman, AuburnBank and ANBC,  
Business Owner

Edward Lee Spencer, III  
Investor

Dr. Emil F. Wright, Jr.  
Vice Chairman  
AuburnBank and ANBC,  
Retired Ophthalmologist



## AUBURNBANK OFFICERS

E.L. Spencer, Jr.  
Chairman

Robert W. Dumas  
President & Chief  
Executive Officer

Jo Ann Hall  
Executive Vice President,  
Chief Operations Officer/  
Chief Risk Officer

Terrell E. Bishop  
Senior Vice President,  
Senior Mortgage Loan Officer

James E. Dulaney  
Senior Vice President,  
Business Development/Marketing

W. Thomas Johnson  
Senior Vice President,  
Senior Lender

Marla Kickliter  
Senior Vice President,  
Compliance/Internal Audit

Shannon O'Donnell  
Senior Vice President,  
Credit Administration

Jerry Siegel  
Senior Vice President, IT/IS  
Chief Technology Officer

C. Eddie Smith  
Senior Vice President,  
City President, Opelika Branch

Bob R. Adkins  
Vice President,  
Commercial/Consumer Loans

Patty Allen  
Vice President,  
Commercial/Consumer Loans

Scottie Arnold  
Vice President,  
Retail Internet/  
Operations Officer

Kris Blackmon  
Vice President,  
Asset/Liability Manager  
Chief Investment Officer

S. Mark Bridges  
Vice President,  
Commercial/Consumer Loans

Laura Carrington  
Vice President,  
Human Resource Officer

Kathy Crawford  
Vice President,  
Commercial/Consumer Loans

David Hedges  
Vice President, Controller  
and CFO

Ginnie Y. Lunsford  
Vice President,  
Consumer Loans/  
Loan Operations

Susan K. McChesney  
Vice President, IT/IS

Julia McCreight  
Vice President,  
Mortgage Loans

David Reaves  
Vice President,  
Mortgage Loans

John P. Ronan  
Vice President,  
Commercial/Consumer Loans

Robert Smith  
Vice President,  
Commercial/Consumer Loans

David Warren  
Vice President,  
Commercial/Consumer Loans

Barbara Wilcox  
Vice President,  
Security and Bank  
Secrecy Act Officer

Suzanne Gibson  
Assistant Vice President,  
Portfolio Management Officer

Julie Ambrose  
Mortgage Loan Officer

Charlotte Lang  
Assistant Bank Secrecy Act Officer  
and Operations Officer

Woody Odom  
Information Systems Officer

Marcia Otwell  
Shareholder Relations and  
Administrative Officer

Jeff Stewart  
Consumer Loan Officer

Christy A. Fogle  
Loan Review Officer

Sam S. Rainer  
Marketing Officer

James R. Pack  
Vice President,  
Financial Reporting

## OPELIKA BRANCH ADVISORY BOARD



### 2010 Opelika Branch Advisory Board

Seated left to right: C. Eddie Smith, Sherrie M. Stanyard, William H. Brown  
Standing: William G. Dyas, Robert G. Young, R. Kraig Smith, M.D.,  
William P. Johnston, Doug M. Horn  
Not pictured: Michael James

William H. Brown  
President, Brown Agency, Inc.

William G. Dyas  
Businessman

Doug M. Horn  
Owner, Doug Horn Roofing  
& Contracting Co.

Michael James  
Senior Vice President,  
Castone Corporation

William P. Johnston  
President, J & M Bookstore

C. Eddie Smith  
President,  
AuburnBank of Opelika

R. Kraig Smith, M.D.  
Lee OBGYN

Sherrie Murphy Stanyard  
Senior Account Manager,  
Craftmaster Printers, Inc.

Robert G. Young  
Vice President, Sales  
Young's Plant Farm, Inc.

# FINANCIAL HIGHLIGHTS

Auburn National Bancorporation, Inc.  
Financial Highlights  
(Dollars in thousands, except per share data)

	For the Year Ended December 31,				
	2010	2009	2008	2007	2006
<b>Earnings</b>					
Net Interest Income	\$18,899	\$18,815	\$17,870	\$15,605	\$14,923
Provision for Loan Losses	3,580	5,250	870	23	330
Net Earnings	5,346	2,404	6,637	6,918	6,585
Per Share:					
Net Earnings	1.47	0.66	1.81	1.86	1.74
Cash Dividends	0.78	0.76	0.74	0.70	0.64
Book Value	15.47	15.42	15.66	14.40	12.93
Shares Issued	3,957,135	3,957,135	3,957,135	3,957,135	3,957,135
Weighted Average Shares Outstanding	3,642,851	3,644,691	3,674,384	3,716,427	3,777,721
<b>Financial Condition</b>					
Total Assets	763,829	\$773,382	\$745,970	\$688,659	\$635,126
Loans, net of unearned income	374,215	376,103	369,162	322,411	281,983
Investment Securities	315,220	334,762	302,656	318,373	301,937
Total Deposits	607,127	579,409	550,843	492,585	469,648
Long Term Debt	93,331	118,349	123,368	115,386	90,404
Shareholder's Equity	56,368	56,183	57,128	53,018	48,418
<b>Selected Ratios</b>					
Return on Average Total Assets	0.68%	0.31%	0.92%	1.06%	1.06%
Return on Average Total Equity	9.00%	4.23%	12.18%	13.50%	14.66%
Average Stockholders' Equity to Average Assets	7.61%	7.21%	7.59%	7.88%	7.20%
Allowance for Loan Losses as a % of Loans	2.05%	1.73%	1.19%	1.27%	1.43%
Loans to Total Deposits	61.64%	64.91%	67.01%	65.45%	60.04%

Certain reclassifications have been made to prior years' financial information to conform to the current year presentation.



**AUBURN BANK**

SINCE 1907  
YOUR PARTNER, YOUR NEIGHBOR,  
YOUR FRIEND

# Financial Section

Auburn National Bancorporation, Inc. 2010 Annual Report

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### SPECIAL CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Various of the statements made herein under the captions “Management’s Discussion and Analysis of Financial Condition and Results of Operations”, “Quantitative and Qualitative Disclosures about Market Risk”, “Risk Factors” and elsewhere, are “forward-looking statements” within the meaning and protections of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause the actual results, performance or achievements of the Company to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. You should not expect us to update any forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as “may,” “will,” “anticipate,” “assume,” “should,” “indicate,” “would,” “believe,” “contemplate,” “expect,” “estimate,” “continue,” “further,” “plan,” “point to,” “project,” “could,” “intend,” “target” and other similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation, (i) the effects of future economic, business and market conditions and changes, domestic and foreign, including seasonality; (ii) governmental monetary and fiscal policies; (iii) legislative and regulatory changes, including changes in banking, securities and tax laws, regulations and rules and their application by our regulators, including capital and liquidity requirements, and changes in the scope and cost of FDIC insurance and other coverage; (iv) changes in accounting policies, rules and practices; (v) the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities, and the risks and uncertainty of the amounts realizable and the timing of dispositions of assets by the FDIC where we may have a participation or other interest; (vi) changes in borrower credit risks and payment behaviors; (vii) changes in the availability and cost of credit and capital in the financial markets, and the types of instruments that may be included as capital for regulatory purposes; (viii) changes in the prices, values and sales volumes of residential and commercial real estate; (ix) the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services; (x) the failure of assumptions and estimates underlying the establishment of reserves for possible loan losses and other estimates; (xi) the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions; (xii) changes in technology or products that may be more difficult, costly, or less effective than anticipated; (xiii) the effects of war or other conflicts, acts of terrorism or other catastrophic events that may affect general economic conditions; (xiv) the failure of assumptions and estimates, as well as differences in, and changes to, economic, market and credit conditions, including changes in borrowers’ credit risks and payment behaviors from those used in our loan portfolio stress test; (xv) the risks that our deferred tax assets could be reduced if estimates of future taxable income from our operations and tax planning strategies are less than currently estimated, and sales of our capital stock could trigger a reduction in the amount of net operating loss carry-forwards that we may be able to utilize for income tax purposes; and (xvi) other factors and risks described under “Risk Factors” herein and in any of our subsequent reports that we make with the Securities and Exchange Commission (the “Commission” or “SEC”) under the Exchange Act.

All written or oral forward-looking statements that are made by us or are attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made. A more detailed description of these and other risks is contained in the Company’s 2010 Annual Report on Form 10-K and in any of our subsequent reports that we make with the Securities and Exchange Commission (the “Commission” or “SEC”) under the Exchange Act.



## BUSINESS INFORMATION

Auburn National Bancorporation, Inc.'s (the "Company's") business is conducted primarily through AuburnBank (the "Bank") and its subsidiaries. Although it has no immediate plans to conduct any other business, the Company may engage directly or indirectly in a number of activities that the Federal Reserve has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

The Company's principal executive offices are located at 100 N. Gay Street, Auburn, Alabama 36830, and its telephone number at such address is (334) 821-9200. The Company maintains an Internet website at [www.auburnbank.com](http://www.auburnbank.com). The Company is not incorporating the information on that website into this report, and the website and the information appearing on the website are not included in, and are not part of, this report. The Company files annual, quarterly and current reports, proxy statements, and other information with the SEC. You may read and copy any document we file with the SEC at the SEC's public reference room at 100 F Street, N.E., Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for more information on the operation of the public reference rooms. The SEC maintains an Internet site that contains reports, proxy, and other information. Our SEC filings are also available to the public free of charge from the SEC's web site at [www.sec.gov](http://www.sec.gov).

### Services

The Bank offers checking, savings, transaction deposit accounts and certificates of deposit, and is an active residential mortgage lender in its primary service area ("PSA"). The Bank's PSA includes the cities of Auburn and Opelika, Alabama and nearby surrounding areas in East Alabama, primarily in Lee County. The Bank also offers commercial, financial, agricultural, real estate construction and consumer loan products and other financial services. The Bank is one of the largest providers of automated teller services in East Alabama and operates ATM machines in 12 locations in its PSA. The Bank offers Visa® Checkcards, which are debit cards with the Visa logo that work like checks but can be used anywhere Visa is accepted, including ATMs. The Bank's Visa Checkcards can be used internationally through the Cirrus® network. The Bank offers online banking and bill payment services through its Internet website, [www.auburnbank.com](http://www.auburnbank.com).

### Loans and Loan Concentrations

The Bank makes loans for commercial, financial and agricultural purposes, as well as for real estate mortgages, real estate acquisition, construction and development and consumer purposes. While there are certain risks unique to each type of lending, management believes that there is more risk associated with commercial, real estate acquisition, construction and development, agricultural and consumer lending than with residential real estate mortgage loans. To help manage these risks, the Bank has established underwriting standards used in evaluating each extension of credit on an individual basis, which are substantially similar for each type of loan. These standards include a review of the economic conditions affecting the borrower, the borrower's financial strength and capacity to repay the debt, the underlying collateral and the borrower's past credit performance. These standards are used to determine the creditworthiness of the borrower at the time a loan is made and are monitored periodically throughout the life of the loan. See "Legislative and Regulatory Changes" for a discussion of regulatory guidance on commercial real estate lending.

The Bank has loans outstanding to borrowers in all industries within its PSA. Any adverse economic or other conditions affecting these industries would also likely have an adverse effect on the local workforce, other local businesses, and individuals in the community that have entered into loans with the Bank. However, management believes that due to the diversified mix of industries located within the Bank's PSA, adverse changes in one industry may not necessarily affect other area industries to the same degree or within the same time frame. The Bank's PSA is also subject to both local and national economic conditions and fluctuations. While most loans are made within the PSA, residential mortgage loans are originated outside the PSA, and the Bank has from time to time purchased loans and loan participations from outside its PSA.

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

The following is a discussion of our financial condition at December 31, 2010 and 2009 and our results of operations for the years ended December 31, 2010, 2009, and 2008. The purpose of this discussion is to provide information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein. In addition, this discussion and analysis contains forward-looking statements, so you should refer to Item 1A, "Risk Factors" and "Special Cautionary Notice Regarding Forward-Looking Statements".

Certain amounts reported in prior periods have been reclassified to conform to the current-period presentation. These reclassifications had no effect on the Company's previously reported stockholders' equity or net earnings during the periods involved.

**OVERVIEW**

The Company was incorporated in 1990 under the laws of the State of Delaware and became a bank holding company after it acquired its Alabama predecessor, which was a bank holding company established in 1984. The Bank, the Company's principal subsidiary, is an Alabama state-chartered bank that is a member of the Federal Reserve System and has operated continuously since 1907. Both the Company and the Bank are headquartered in Auburn, Alabama. The Bank conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, Hurtsboro and Notasulga, Alabama. In-store branches are located in the Auburn and Opelika Kroger stores, as well as Wal-Mart SuperCenter stores in Auburn, Opelika and Phenix City, Alabama. Mortgage loan offices are located in Phenix City, Valley, and Mountain Brook, Alabama.

**Summary of Results of Operations**

	Years ended December 31		
	2010	2009	2008
<i>(Dollars in thousands, except per share amounts)</i>			
Net interest income (a)	\$ 20,664	\$ 20,448	\$ 19,231
Less: tax-equivalent adjustment	1,765	1,633	1,361
Net interest income (GAAP)	18,899	18,815	17,870
Noninterest income	7,266	3,132	4,202
Total revenue	26,165	21,947	22,072
Provision for loan losses	3,580	5,250	870
Noninterest expense	16,441	14,633	12,542
Income tax expense (benefit)	798	(340)	2,023
Net earnings	\$ 5,346	\$ 2,404	\$ 6,637
Basic and diluted earnings per share	\$ 1.47	\$ 0.66	\$ 1.81

(a) Tax-equivalent. See "Table 1 - Explanation of Non-GAAP Financial Measures".

**Financial Summary**

The Company's net earnings were \$5.3 million, or \$1.47 per share, for the full year 2010, compared to \$2.4 million, or \$0.66 per share, for the full year 2009.

Tax-equivalent net interest income increased 1% in 2010 from 2009 as improvement in the Company's net interest margin offset a decrease in total interest earning assets during 2010. Average total interest earning assets decreased 2% in 2010 when compared to 2009 as cash proceeds from securities sold, called, and matured in 2010 were used to reduce short-term borrowings and higher cost long-term debt. Average loans of \$377.2 million in 2010 were relatively stable when compared to 2009 despite weak loan demand and a challenging economic environment.

The impact of continuing economic distress, elevated net charge-offs and nonperforming loans were the primary reason for the level of provision expense in 2010. As a result, the Company increased its allowance for loan losses as a percentage of total loans during 2010. The provision for loan losses amounted to \$3.6 million in 2010, compared to \$5.3 million in 2009. The provision for loan losses declined in 2010 when compared to 2009 due to a decline in net charge-offs and nonperforming loan inflows. Net charge-offs as a percentage of average loans were 0.64% in 2010, compared to 0.84% in 2009.

Noninterest income was \$7.3 million in 2010, compared to \$3.1 million in 2009. This increase primarily reflects a decline in other-than-temporary impairment charges of approximately \$4.5 million in 2010 when compared to 2009.

Noninterest expense was \$16.4 million in 2010, compared to \$14.6 million in 2009. This increase primarily reflects an increase in net other real estate owned expense of \$1.3 million and prepayment penalties of \$0.7 million on long-term debt in 2010 when compared to 2009.

Income tax expense for 2010 was \$0.8 million, compared to an income tax benefit of \$0.3 million in 2009. The effective income tax rate was 12.99% in 2010, compared to an effective income tax benefit rate of 16.47% in 2009. This change was primarily due to a significant increase in the level of earnings before taxes in 2010 when compared to 2009.

In 2010, the Company paid cash dividends of \$2.8 million, or \$0.78 per share. The Company's balance sheet remains strong and well capitalized under current regulatory guidelines with a total risk-based capital ratio of 15.82%, a tier one risk-based capital ratio of 14.57%, and a tier one leverage capital ratio of 8.47% at December 31, 2010.

## **CRITICAL ACCOUNTING POLICIES**

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles, or GAAP, and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses, our assessment of other-than-temporary impairment, recurring and non-recurring fair value measurements, valuation of other real estate owned, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

### **Allowance for Loan Losses**

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolios, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loan losses are charged off when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a "confirming event" has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely. Allocation of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, is deemed to be uncollectible.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized on impaired loans if the fair value of the loan is less than the recorded investment in the loan (recorded investment in the loan is the principal balance plus any accrued interest, net of deferred loan fees or costs and unamortized premium or discount). The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan's effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs. The Company believes it follows appropriate accounting and regulatory guidance in determining impairment and accrual status of impaired loans.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing independent loan review process. The Company's loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the loan portfolio. The Company's loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates

loan review results in the determination of whether or not it is probable that we will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial loans, construction and land development loans, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2010, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups. The related adjustments increased the allowance for loan losses for this portfolio segment at December 31, 2010.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management's estimate of probable losses for several "qualitative and environmental" factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company maintains an unallocated amount for inherent factors that cannot be practically assigned to individual loan segments or categories. An example is the imprecision in the overall measurement process.

The Company constantly re-evaluates its practices in determining the allowance for loan losses. During 2010, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Prior to September 30, 2010, the Company calculated average losses by loan segment using a rolling 12 quarter historical period. In order to better capture the effect of current economic conditions on the Company's loan loss experience, the Company calculated average losses by loan segment using a rolling 6 quarter historical period beginning with the quarter ended September 30, 2010. Correspondingly, the Company reduced the level of adjustments made to historical losses for "qualitative and environmental factors" since the updated historical losses were more representative of current economic conditions. The net effect of these changes increased the Company's calculated allowance for loan loss allocation and the related provision for loan losses by approximately \$0.8 million for the quarter ended September 30, 2010.

### **Assessment for Other-Than-Temporary Impairment of Securities**

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses).

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the entity will be required to sell the debt security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings, as a realized loss in securities gains (losses), and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The



remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

The Company assesses impairment for pooled trust preferred securities using a cash flow model. The key assumptions include default probabilities of the underlying collateral and recoveries on collateral defaults. These assumptions may have a significant effect on the determination of the present value of expected future cash flows and the resulting amount of other-than-temporary impairment. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

### **Fair Value Determination**

GAAP requires management to value and present at fair value certain of the Company's assets and liabilities, including investments classified as available-for-sale and derivatives. FASB ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 16 of the consolidated financial statements that accompany this report.

Fair values are based on market prices when available. However, some of the Company's transactions lack an available trading market characterized by frequent transactions between a willing buyer and seller. In these cases, such values are estimated using pricing models that use discounted cash flows and other pricing techniques. Pricing models and their underlying assumptions are based upon management's best estimates for appropriate discount rates, default rates, prepayments, market volatility and other factors, taking into account current observable market data and experience.

These assumptions may have a significant effect on the reported fair values of assets and liabilities and the related income and expense. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

### **Other Real Estate Owned**

Other real estate owned ("OREO"), consists of properties obtained through foreclosure or in satisfaction of loans, is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal realized at the time of disposal are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of other real estate owned, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility, as experienced during 2010. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other real estate owned.

### **Deferred Tax Asset Valuation**

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of taxable income over the last three years and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the we will realize the benefits of these deductible differences at December 31, 2010. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the future periods are reduced.

**Average Balance Sheet and Interest Rates**

	Years ended December 31					
	2010		2009		2008	
	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
<i>(Dollars in thousands)</i>						
Loans and loans held for sale	\$ 380,552	5.73%	\$ 380,434	5.75%	\$ 347,176	6.47%
Securities - taxable	246,610	3.33%	269,266	4.37%	258,160	5.11%
Securities - tax-exempt	81,256	6.39%	74,794	6.42%	62,801	6.37%
Total securities	327,866	4.09%	344,060	4.82%	320,961	5.36%
Federal funds sold	13,984	0.21%	10,138	0.23%	3,197	1.91%
Interest bearing bank deposits	1,076	0.09%	1,135	0.09%	511	2.74%
Total interest-earning assets	723,478	4.87%	735,767	5.23%	671,845	5.91%
Deposits:						
NOW	88,070	0.69%	90,794	0.95%	75,461	2.08%
Savings and money market	117,725	1.04%	93,484	1.13%	103,379	1.76%
Certificates of deposits less than \$100,000	113,912	2.42%	112,894	3.32%	95,830	4.33%
Certificates of deposits and other time deposits of \$100,000 or more	197,387	2.76%	221,028	3.39%	172,592	4.37%
Total interest-bearing deposits	517,094	1.94%	518,200	2.54%	447,262	3.37%
Short-term borrowings	3,530	0.65%	10,790	0.51%	16,604	1.95%
Long-term debt	112,312	4.02%	120,248	4.01%	123,108	4.14%
Total interest-bearing liabilities	632,936	2.30%	649,238	2.78%	586,974	3.49%
Net interest income and margin (a)	\$ 20,664	2.86%	\$ 20,448	2.78%	\$ 19,231	2.86%

(a) Tax-equivalent. See "Table 1 - Explanation of Non-GAAP Financial Measures".

**RESULTS OF OPERATIONS**
**Net Interest Income and Margin**
2010 vs. 2009 comparison

Tax-equivalent net interest income increased 1% in 2010 from 2009 as improvement in the Company's net interest margin offset the decrease in total interest earning assets.

The tax-equivalent yield on total interest earning assets decreased 36 basis points in 2010 from 2009 to 4.87%. This decrease was primarily due to a decline of 104 basis points in the yield on taxable securities to 3.33%.

The cost of total interest-bearing liabilities decreased 48 basis points in 2010 from 2009, to 2.30%. This decrease was primarily due to a 60 basis point decrease in the cost of total interest-bearing deposits to 1.94%.

2009 vs. 2008 comparison

Tax-equivalent net interest income increased 6% in 2009 from 2008 due to balance sheet growth. Net interest margin decreased 8 basis points to 2.78%.

The tax-equivalent yield on total interest earning assets decreased 68 basis points in 2009 from 2008 to 5.23%. This decrease was comprised of a 72 basis point decrease in the yield on loans and loans held for sale to 5.75% and a 54 basis point decrease in the tax-equivalent yield on total securities to 4.82%.

The cost of total interest-bearing liabilities decreased 71 basis points in 2009 from 2008, to 2.78%. This decrease was comprised of an 83 basis point increase in the cost of total interest-bearing deposits to 2.54%, a 144 basis point decrease in the cost of short-term borrowings to 0.51% and a 13 basis point decrease in the cost of long-term debt to 4.01%.

## Provision for Loan Losses

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the probable losses on outstanding loans. The provision for loan losses amounted to \$3.6 million, \$5.3 million, and \$0.9 million for the years ended December 31, 2010, 2009 and 2008, respectively.

The impact of continuing economic distress, elevated net charge-offs and nonperforming loans were the primary reason for the level of provision expense in 2010. As a result, the Company increased its allowance for loan losses as percentage of total loans during 2010. The provision for loan losses declined in 2010 when compared to 2009 due to a decline in net charge-offs and nonperforming loan inflows. Also, the provision for loan losses in 2009 was impacted by \$2.8 million in impairments related to the deterioration of two construction and land development loans.

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes should be appropriate to adequately cover probable losses in the loan portfolio. The Company's allowance for loan losses to total loans increased to 2.05% at December 31, 2010 from 1.73% at December 31, 2009. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2010. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are believed adequate by management and are reviewed from time to time by our regulators, they are necessarily approximate and imprecise. There exist factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions which may negatively impact, materially, our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

## Noninterest Income

(Dollars in thousands)	Years ended December 31		
	2010	2009	2008
Service charges on deposit accounts	\$ 1,280	\$ 1,243	\$ 1,252
Mortgage lending	3,042	4,048	1,694
Bank-owned life insurance	452	424	470
Securities gains (losses), net	1,423	(3,703)	(1,168)
Other	1,069	1,120	1,954
Total noninterest income	\$ 7,266	\$ 3,132	\$ 4,202

The Company's income from mortgage lending is primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing of mortgage loans. Origination income is comprised of gains or losses from the sale of the mortgage loans originated, origination fees, underwriting fees and other fees associated with the origination of loans. The Company's normal practice is to originate mortgage loans for sale in the secondary market and to either release or retain the associated mortgage servicing rights ("MSRs") when the loan is sold. MSRs are recognized based on the fair value of the servicing right on the date the corresponding mortgage loan is sold. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Servicing fee income is reported net of any related amortization expense.

The following table presents a breakdown of the Company's mortgage lending income for 2010, 2009 and 2008:

(Dollars in thousands)	Years ended December 31		
	2010	2009	2008
Origination income	\$ 2,691	\$ 3,701	\$ 1,375
Servicing fees, net	351	347	319
Total mortgage lending income	\$ 3,042	\$ 4,048	\$ 1,694

### 2010 vs. 2009 comparison

Mortgage lending income was \$3.0 million in 2010, compared to \$4.0 million in 2009. A significant decline in the level of mortgage refinance activity during 2010 when compared to the record levels experienced during 2009 contributed to the decrease in mortgage lending income. The Company's income from mortgage lending typically fluctuates as mortgage interest rates change and is primarily attributable to origination and sale of new mortgage loans.

The net gain on securities was \$1.4 million in 2010, compared to a net loss of \$3.7 million in 2009. Gross realized gains of \$3.5 million in 2010 were offset by gross realized losses of \$2.1 million. Gross realized losses in 2010 primarily related to other-than-temporary impairment charges for trust preferred securities and corporate debt securities. Gross realized losses of \$6.6 million in 2009 primarily related to other-than-temporary impairment charges for trust preferred securities and an investment in the common stock of Silverton Financial Services, Inc. These losses were offset by gross realized gains of \$2.9 million during the same period.

2009 vs. 2008 comparison

Mortgage lending income was \$4.0 million in 2009, compared to \$1.7 million in 2008. Significantly increased volume and better pricing during 2009 when compared to 2008 contributed to higher mortgage lending income during 2009.

The total net loss on securities was \$3.7 million in 2009, compared to \$1.2 million in 2008. Gross realized losses of \$6.6 million in 2009 primarily related to other-than-temporary impairment charges for trust preferred securities and an investment in the common stock of Silverton Financial Services, Inc. These losses were offset by gross realized gains of \$2.9 million during the same period. Gross realized losses of \$1.6 million in 2008 primarily related to other-than-temporary impairment for one pooled trust preferred security. These losses were offset by gross realized gains of \$0.4 million during the same period.

Other noninterest income was \$1.1 million in 2009, compared to \$2.0 million in 2008. The decrease is primarily due to nonrecurring items included in 2008 totals. In 2008, other noninterest income was impacted by a \$1.1 million gain related to the sale of certain real property. This was offset by a \$0.5 million pre-tax charge in 2008 related to the correction of an accounting error in prior periods. Information concerning the correction of an accounting error is included in Note 1 to the consolidated financial statements that accompany this report.

**Noninterest Expense**

	Years ended December 31		
	2010	2009	2008
(Dollars in thousands)			
Salaries and benefits	\$ 7,950	\$ 7,819	\$ 7,278
Net occupancy and equipment	1,450	1,500	1,314
Professional fees	702	799	511
FDIC and other regulatory assessments	1,092	1,322	358
Other real estate owned, net	1,378	43	67
Prepayment penalty on long-term debt	679	—	—
Other	3,190	3,150	3,014
Total noninterest expense	\$ 16,441	\$ 14,633	\$ 12,542

2010 vs. 2009 comparison

Salaries and benefits expense was \$8.0 million in 2010, compared to \$7.8 million in 2009. The increase in 2010 when compared to 2009 was primarily due to increased salaries expense and group medical insurance costs. Offsetting the increase in salaries expense and group medical insurance costs was a decrease in commissions paid to our mortgage originators as a result of decreased origination volume in 2010 when compared to 2009. No cash incentive awards were accrued for Company or Bank officers in 2010 or 2009.

FDIC and other regulatory assessments expense was \$1.1 million in 2010, compared to \$1.3 million in 2009. The decrease in 2010 when compared to 2009 was primarily due to the impact of the \$0.4 million special assessment from the FDIC included in FDIC and other regulatory assessments expense in 2009.

Other real estate owned expense, net increased by \$1.3 million in 2010 when compared to 2009. The increase was primarily due to write-downs of the carrying value of certain foreclosed properties due to deterioration in real estate values.

Prepayment penalties on long-term debt were approximately \$0.7 million during 2010 compared to nil during 2009. As part of its strategy to reduce wholesale funding and interest expense, the Company repaid \$10.0 million of securities sold under agreements to repurchase prior to their maturity that were included in long-term debt during 2010.



### 2009 vs. 2008 comparison

Salaries and benefits expense was \$7.8 million in 2009, compared to \$7.3 million in 2008. The primary driver of the increase related to increases in commissions paid to our mortgage originators as a result of increased origination volume. Increases in normal annual officer and employee salaries and wages in 2009 were offset by a reduction in the payout related to the Company's annual cash incentive awards. No cash incentive awards were accrued for Company and Bank officers in 2009.

Net occupancy and equipment expense was \$1.5 million in 2009, compared to \$1.3 million in 2008. The primary driver of the increase relates to start-up costs for a new branch that was opened in the first quarter of 2009 and the related increases in operating costs and depreciation expense.

Professional fees expense was \$0.8 million in 2009, compared to \$0.5 million in 2008. The increase primarily relates to increased costs of regulatory compliance, including Sarbanes-Oxley and other legislative and regulatory measures.

FDIC and other regulatory assessments expense was \$1.3 million in 2009, compared to \$0.4 million in 2008. This change was primarily a result of the significant increase in the Company's FDIC insurance assessments in 2009, despite being assessed at the FDIC's lowest rate. As a result of the requirement to increase the FDIC's Deposit Insurance Fund ("DIF") to statutory levels over a prescribed period of time and increased pressure on the fund's reserves due to the increasing number of bank failures, annual FDIC insurance costs were significantly higher for all insured depository institutions. Also, during the second quarter of 2009, a special assessment from the FDIC of approximately \$0.4 million was accrued to provide additional reserves for the FDIC's DIF.

## **Income Tax Expense**

### 2010 vs. 2009 comparison

In 2010, the Company recorded income tax expense of \$0.8 million, compared to an income tax benefit of \$0.3 million in 2009. This change was primarily due to an increase in the level of earnings before taxes. The effective income tax rate was 12.99% in 2010, compared to an effective income tax benefit rate of 16.47% in 2009. The increase in the effective tax rate from 2009 to 2010 was primarily due to a 198% increase in earnings before taxes. Also reflected in the Company's effective income tax benefit rate for 2009 was a change in valuation allowance of \$0.5 million related to nondeductible capital losses and an income tax benefit of \$0.3 million related to the correction of an accounting error in prior periods. Information concerning the correction of an accounting error is included in "Note 1 to the Consolidated Financial Statements."

### 2009 vs. 2008 comparison

In 2009, the Company recorded an income tax benefit of \$0.3 million, compared to income tax expense of \$2.0 million in 2008. This change was primarily due to a decrease in the level of earnings before taxes relative to tax-exempt sources of income in 2009 when compared to 2008. The effective income tax benefit rate was 16.47% in 2009, compared to an effective income tax rate of 23.36%. The decrease in the effective tax rate from 2008 to 2009 was primarily due to a 76% decrease in earnings before taxes while tax-exempt sources of income remained relatively consistent in both years.

## **BALANCE SHEET ANALYSIS**

### **Securities**

Securities available-for-sale were \$315.2 million and \$334.8 million as of December 31, 2010 and 2009, respectively. The decrease from December 31, 2009 primarily reflects management's decision to utilize a portion of the cash proceeds from sales/calls/maturities of investment securities during 2010 to reduce short-term borrowings and higher cost long-term debt. Unrealized net losses on securities available-for-sale were \$3.5 million as of December 31, 2010 compared to unrealized net gains of \$0.2 million as of December 31, 2009. The increase in unrealized net losses of \$3.7 million from December 31, 2009 was primarily due to changes in interest rates and increased credit spreads on municipal bonds. The average tax-equivalent yields earned on total securities were 4.09% in 2010 and 4.82% in 2009.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2010 according to contractual maturity. Actual maturities may differ from contractual maturities of mortgage-backed securities because the mortgages underlying the securities may be called or prepaid with or without penalty.

	December 31, 2010				
	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Total Fair Value
<i>(Dollars in thousands)</i>					
Agency obligations	\$ —	—	37,821	52,650	90,471
Agency RMBS	—	—	9,976	133,168	143,144
State and political subdivisions	21	856	13,547	62,342	76,766
Trust preferred securities	—	—	—	2,149	2,149
Corporate debt	—	2,690	—	—	2,690
Total available-for-sale	\$ 21	3,546	61,344	250,309	315,220
<b>Weighted average yield:</b>					
Agency obligations	—	—	2.54%	2.43%	2.48%
Agency RMBS	—	—	1.57%	3.21%	3.09%
State and political subdivisions	5.25%	4.72%	4.16%	4.25%	4.24%
Trust preferred securities	—	—	—	1.40%	1.40%
Corporate debt	—	6.93%	—	—	6.93%
Total available-for-sale	5.25%	6.41%	2.73%	3.29%	3.22%

## Loans

	December 31				
	2010	2009	2008	2007	2006
<i>(In thousands)</i>					
Commercial and industrial	\$ 53,288	53,884	53,883	50,797	45,702
Construction and land development	47,850	56,820	67,420	45,724	24,683
Commercial real estate	166,241	156,928	132,818	120,789	109,774
Residential real estate	96,241	97,407	102,835	93,888	92,830
Consumer installment	10,676	11,236	12,463	11,525	9,328
Total loans	374,296	376,275	369,419	322,723	282,317
Less: unearned income	(81)	(172)	(257)	(312)	(334)
Loans, net of unearned income	\$ 374,215	376,103	369,162	322,411	281,983

Total loans, net of unearned income, were \$374.2 million as of December 31, 2010, a decrease of \$1.9 million, or 1%, from \$376.1 million at December 31, 2009. The loan portfolio decreased slightly in 2010 as new loans were unable to offset the impact of paydowns, charge-offs, foreclosures and other problem loan resolutions. Four loan categories represented the majority of the loan portfolio as December 31, 2010. Commercial real estate mortgage loans represented 44%, residential real estate mortgage loans represented 26%, commercial and industrial loans represented 14% and construction and land development loans represented 13% Company's total loans at December 31, 2010. The primary change in the composition of the loan portfolio during 2010 is due to an increase in commercial real estate mortgage loans of \$9.3 million and a decrease in construction and land development loans of \$9.0 million.

Within the residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately \$24.3 million, or 6%, and \$25.9 million, or 7%, of total loans, net of unearned income at December 31, 2010 and 2009, respectively. For residential real estate mortgage loans with a consumer purpose, approximately \$4.1 million and \$5.8 million required interest only payments at December 31, 2010 and 2009, respectively. The Company's residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high risk consumer mortgage products.

Purchased loan participations included in the Company's loan portfolio were approximately \$7.2 million and \$9.4 million as of December 31, 2010 and 2009, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company's normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures as described in "CRITICAL ACCOUNTING POLICIES."

The average yield earned on loans and loans held for sale was 5.73% in 2010 and 5.75% in the 2009.

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the impact of recessionary economic conditions on our borrowers' cash flows, real estate market sales volumes, valuations, and availability and cost of financing for properties, real estate industry concentrations, deterioration in certain credits, interest rate fluctuations, reduced collateral values or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and any violation of laws and regulations.

The Company attempts to reduce these economic and credit risks by adhering to loan to value ("LTV") guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers' financial position. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit our credit exposure by prohibiting unsecured loan relationships that exceed 10% of the capital accounts of the Bank; or 20% of the capital accounts if loans in excess of 10% are fully secured, which would approximate \$13.5 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$12.1 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At December 31, 2010, the Company had no loan relationships exceeding these limits.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any one or more industries. We use broadly accepted industry classification systems in order to classify borrowers into various industry classifications. Loan concentrations to borrowers in the following industries exceeded 25% of the Bank's total risk-based capital at December 31, 2010 (and related balances at December 31, 2009).

	December 31	
	2010	2009
(In thousands)		
Lessors of 1-4 family residential properties	\$ 38,679	34,961
Office buildings	24,185	21,122
Manufacturing/industrial facilities	17,327	14,715

At December 31, 2010 the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas. Although not a significant concentration, the Company has some exposure to geographic areas that could be affected by the oil spill in the Gulf of Mexico. In addition to the Gulf of Mexico being a popular vacation destination for borrowers located in our primary trade area, the Company also operated a loan production office in the Gulf Shores/Orange Beach, Alabama area from 2004 to 2008. Separately, the Company previously purchased participations in two construction and land development loans related to projects along the Florida Gulf Coast. Management will continue to monitor the Company's exposure and prospective provisions for loan losses will incorporate any deterioration in affected loan segments as necessary.

The following table summarizes the Company's total exposure to loans secured by real estate and other real estate owned in geographic areas that could be affected by the oil spill.

	December 31	
	2010	2009
(In thousands)		
Construction and land development	\$ 2,484	4,926
Residential real estate	6,720	7,094
Total loans	9,204	12,020
Other real estate owned	3,559	4,329
Total exposure	\$ 12,763	16,349
as a % of total assets	1.67%	2.11%

At December 31, 2010, the Company had approximately \$6.7 million of loans secured by residential real estate in coastal counties along the Gulf of Mexico that could be affected by the oil spill. These locations include Baldwin County, Alabama, and Bay, Escambia, Okaloosa and Walton County, Florida.

At December 31, 2010, the carrying value related to one of the Company's purchased participations was \$2.5 million. At December 31, 2010, this loan was classified as a troubled-debt restructuring ("TDR") and nonaccrual loan.

The other purchased participation loan defaulted and was foreclosed upon previously. At December 31, 2010, the

carrying value of the Company's interest in this foreclosed property was approximately \$3.6 million and is included in other real estate owned which is discussed more fully under "Nonperforming Assets" below.

### Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level that management deems appropriate to adequately cover the Company's estimate of probable losses in the loan portfolio. As of December 31, 2010 and 2009, respectively, the allowance for loan losses was \$7.7 million and \$6.5 million, respectively, which management deemed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under "CRITICAL ACCOUNTING POLICIES".

A summary of the changes in the allowance for loan losses and certain asset quality ratios for each of the five years in the five year period ended December 31, 2010 is presented below.

	Years ended December 31				
(Dollars in thousands)	2010	2009	2008	2007	2006
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 6,495	4,398	4,105	4,044	3,843
Charge-offs:					
Commercial and industrial	(537)	(495)	(454)	(62)	(37)
Construction and land development	(1,487)	(2,088)	—	—	—
Commercial real estate	—	—	—	—	—
Residential real estate	(552)	(704)	(153)	(143)	(106)
Consumer installment	(111)	(61)	(98)	(45)	(46)
Total charge-offs	(2,687)	(3,348)	(705)	(250)	(189)
Recoveries:					
Commercial and industrial	63	47	102	14	13
Construction and land development	—	50	—	—	—
Commercial real estate	54	—	—	69	7
Residential real estate	151	92	6	199	4
Consumer installment	20	6	20	6	36
Total recoveries	288	195	128	288	60
Net (charge-offs) recoveries	(2,399)	(3,153)	(577)	38	(129)
Provision for loan losses	3,580	5,250	870	23	330
Ending balance	\$ 7,676	6,495	4,398	4,105	4,044
as a % of loans	2.05 %	1.73	1.19	1.27	1.43
as a % of nonperforming loans	65 %	69	99	918	5,617
Net charge-offs as a % of average loans	0.64 %	0.84	0.17	(0.01)	0.05

As noted in the Company's critical accounting policies, management assesses the adequacy of the allowance prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 2.05% at December 31, 2010, compared to 1.73% at December 31, 2009. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken.

Net charge-offs were \$2.4 million, or 0.64% of average loans, in 2010, compared to net charge-offs of \$3.2 million, or 0.84%, in 2009. The decrease in net charge-offs during 2010 when compared to 2009 was primarily due to a decline in charge-offs in the construction and land development portfolio. Approximately \$1.3 million and \$1.5 million in charge-offs for the years ended December 31, 2010 and 2009, respectively, related to two construction and land development loans.

At December 31, 2010, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 65%, compared to 69% at December 31, 2009. The decrease in this ratio was primarily due to an increase in

nonperforming loans that the Company believes are well-collateralized based on current appraisals and other comparable sales data.

At December 31, 2010, the Company's recorded investment in loans considered impaired was \$11.7 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$1.3 million. At December 31, 2009, the Company's recorded investment in loans considered impaired was \$9.7 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$1.3 million.

In addition, our regulators, as an integral part of their examination process, will periodically review the Company's allowance for loan losses, and may require the Company to make additional provisions to the allowance for loan losses based on their judgment about information available to them at the time of their examinations.

### Nonperforming Assets

At December 31, 2010 the Company had \$20.0 million in nonperforming assets compared to \$16.6 million at December 31, 2009. Included in nonperforming assets were nonperforming loans of \$11.8 million and \$9.4 million at December 31, 2010 and 2009, respectively. Nonperforming assets increased during 2010 due to the impact of continuing economic distress. The majority of the balance in nonperforming assets at December 31, 2010 related to deterioration in the construction and land development loan portfolio.

The table below provides information concerning total nonperforming assets and certain asset quality ratios.

	December 31				
(In thousands)	2010	2009	2008	2007	2006
<b>Nonperforming assets:</b>					
Nonaccrual loans	\$ 11,833	9,352	4,431	447	72
Other nonperforming assets (primarily other real estate owned)	8,125	7,292	324	98	—
<b>Total nonperforming assets</b>	<b>\$ 19,958</b>	<b>16,644</b>	<b>4,755</b>	<b>545</b>	<b>72</b>
as a % of loans and foreclosed properties	5.22%	4.34	1.29	0.17	0.03
as a % of total assets	2.61%	2.15	0.64	0.08	0.01
Nonperforming loans as a % of total loans	3.16%	2.49	1.20	0.14	0.03
Accruing loans 90 days or more past due	\$ —	5	104	4	—

The Lee County Association of Realtors ("LCAR") of Alabama reported that the average median residential home price in Lee County for the quarter ended December 31, 2010 was \$183,933, an increase of 13.0% from the same quarter a year earlier. Although the reported increase in home values is a positive sign, the number of homes sold during the quarter ended December 31, 2010 declined by 17.2% from the same quarter a year ago. LCAR also reported that residential inventory at December 31, 2010 was 1,248 homes, an increase of 10.7% from a year earlier and the average number of days on the market for the quarter ended December 31, 2010 was 187 days, an increase of 12.7% from the same quarter last year. Continued weakness in the residential real estate market and the overall economy could adversely affect the Company's volume of nonperforming assets. For additional discussion of risk factors, see Part I "Item 1A. Risk Factors".

The table below provides information concerning the composition of nonaccrual loans at December 31, 2010 and 2009, respectively.

	December 31	
(In thousands)	2010	2009
<b>Nonaccrual loans:</b>		
Commercial and industrial	\$ 521	—
Construction and land development	4,102	7,542
Commercial real estate	4,735	961
Residential real estate	2,474	842
Consumer installment	1	7
<b>Total nonaccrual loans / nonperforming loans</b>	<b>\$ 11,833</b>	<b>9,352</b>



The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At December 31, 2010, the Company had \$11.8 million in loans on nonaccrual, compared to \$9.4 million at December 31, 2009. Total nonperforming loans increased in 2010 despite a decline in nonperforming loan inflows when compared to 2009. Increases in nonperforming commercial and residential real estate mortgage loans of \$3.8 million and \$1.6 million, respectively, were partially offset by a decrease in nonperforming construction and land development loans of \$3.4 million.

Due to the weakening credit status of a borrower, the Company may elect to formally restructure certain loans to facilitate a repayment plan that minimizes the potential losses that we might incur. Restructured loans are classified as impaired loans, and if the loans are on nonaccrual status as of the date of restructuring, the loans are included in the nonaccrual loan balances noted above. Nonaccrual loan balances do not include loans that have been restructured that were performing as of the restructure date. At December 31, 2010 and 2009, respectively, the Company had no accruing restructured loans.

At December 31, 2010, there were no loans 90 days past due and still accruing interest. At December 31, 2009, the Company had \$5 thousand in loans 90 days past due and still accruing interest.

The table below provides information concerning the composition of other real estate owned at December 31, 2010 and 2009, respectively.

	December 31	
	2010	2009
<i>(In thousands)</i>		
<b>Other real estate owned:</b>		
Residential condo developments	\$ 5,494	4,329
New construction	369	490
Developed lots	136	136
Undeveloped land	1,746	2,210
Other	380	127
<b>Total other real estate owned</b>	<b>\$ 8,125</b>	<b>7,292</b>

The Company owned \$8.1 million in other real estate at December 31, 2010, which we had acquired from borrowers, compared to \$7.3 million at December 31, 2009. Other real estate owned primarily relates to three properties with a total carrying value of \$7.2 million at December 31, 2010. One of the properties is a completed condominium project on the Florida Gulf Coast. The Company had previously purchased a participation interest in the first lien mortgage loan on the condominium project on the Florida Gulf Coast from Silverton Bank. Subsequently, this loan defaulted and was foreclosed upon and the Company's interest in the property is currently included in other real estate owned. Following Silverton Bank's failure on May 1, 2009, the FDIC has held this property as the receiver of Silverton Bank. CB Richard Ellis, a national real estate firm, has been managing this property and selling condominiums in the project as a FDIC contractor. The Company depends upon the FDIC and CB Richard Ellis for information regarding this property and its performance. Based upon the latest information available to us, including appraisals, current unit sales, and comparable sales, we believe that the fair value of the Company's interest in these properties, less selling costs, exceeds the Company's recorded investment. During the first quarter of 2011, the Company learned that the FDIC has approved a bulk sale of the condominiums and club amenities, which may speed the disposition of this property in which we hold an interest.

### Potential Problem Loans

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. Potential problem loans, which are not included in nonperforming assets, amounted to \$13.2 million, or 3.5% of total loans outstanding, net of unearned income at December 31, 2010, compared to \$16.8 million, or 4.5% of total loans outstanding, net of unearned income at December 31, 2009. Continued weakness in the residential real estate market and the overall economy has adversely affected the Company's volume of potential problem loans, and these economic conditions are expected to persist for the foreseeable future.

The table below provides information concerning the composition of potential problem loans at December 31, 2010 and 2009, respectively.

(In thousands)	December 31	
	2010	2009
<b>Potential problem loans:</b>		
Commercial and industrial	\$ 413	1,771
Construction and land development	1,075	1,682
Commercial real estate	5,016	5,659
Residential real estate	6,600	7,502
Consumer installment	116	198
Total potential problem loans	\$ 13,220	16,812

At December 31, 2010, approximately \$1.3 million or 10.0% of total potential problem loans were past due at least 30 but less than 90 days.

The following table is a summary of the Company's performing loans that were past due at least 30 days but less than 90 days as of December 31, 2010 and 2009, respectively.

(In thousands)	December 31	
	2010	2009
<b>Performing loans past due 30 to 89 days:</b>		
Commercial and industrial	\$ 124	339
Construction and land development	201	137
Commercial real estate	—	1,048
Residential real estate	2,986	1,626
Consumer installment	29	46
Total performing loans past due 30 to 89 days	\$ 3,340	3,196

## Deposits

(Dollars in thousands)	December 31	
	2010	2009
Noninterest bearing demand	\$ 87,660	\$ 76,497
NOW	82,817	84,297
Money market	107,193	82,433
Savings	23,344	21,302
Certificates of deposit under \$100,000	115,836	114,399
Certificates of deposit and other time deposits of \$100,000 or more	148,616	173,759
Brokered certificates of deposit	41,661	26,722
Total deposits	\$ 607,127	\$ 579,409

Total deposits were \$607.1 million and \$579.4 million at December 31, 2010 and 2009, respectively. The increase in total deposits of \$27.7 million was primarily due to an increase in noninterest bearing demand deposits of \$11.2 million and an increase in brokered certificates of deposit ("CDs") of \$14.9 million. The Company used brokered CDs, an alternative source of cost-effective funding, to replace certain FHLB advances that matured in 2010. The increase in money market account balances of \$24.8 million and the decrease in certificates and other time deposits of \$100,000 or more of \$25.1 million reflect decreases in interest rates and related shifts as customers sought more yield in short-term instruments in a low interest rate environment.

The average rates paid on total interest-bearing deposits were 1.94% in 2010 and 2.54% in 2009. Noninterest bearing deposits were 14% and 13% of total deposits as of December 31, 2010 and 2009, respectively.

## Other Borrowings

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased, securities sold under agreements to repurchase, and other short-term borrowings. The Bank had available federal fund lines totaling \$34.0 million with none outstanding at December 31, 2010, compared to \$34.0 million with

\$12.5 million outstanding at December 31, 2009. The Company has reviewed all available sources of liquidity and believes the current level of available federal funds lines is sufficient. Securities sold under agreements to repurchase totaled \$2.7 million at December 31, 2010, compared to \$3.5 million at December 31, 2009.

The average rates paid on short-term borrowings were 0.65% in 2010 and 0.51% in 2009. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the three-year period ended December 31, 2010 is included in "Note 9 to the Consolidated Financial Statements."

Long-term debt included FHLB advances with an original maturity greater than one year, securities sold under agreements to repurchase with an original maturity greater than one year, and subordinated debentures related to trust preferred securities. The Bank had \$71.1 million and \$86.1 million in long-term FHLB advances at December 31, 2010 and 2009, respectively. The Bank had \$15.0 million and \$25.0 million in securities sold under agreements to repurchase with an original maturity greater than one year December 31, 2010 and 2009, respectively. The Company had \$7.2 million in junior subordinated debentures related to trust preferred securities outstanding at December 31, 2010 and 2009, respectively.

The average rates paid on long-term debt were 4.02% in 2010 and 4.01% in 2009.

### CAPITAL ADEQUACY

The Company's consolidated stockholders' equity was \$56.4 million and \$56.2 million as of December 31, 2010 and 2009, respectively. The slight increase was a result of net earnings of \$5.3 million offset by cash dividends of \$2.8 million and an other comprehensive loss of \$2.3 million due to changes in unrealized gains (losses) on securities available-for-sale, net.

The Company's Tier 1 leverage ratio was 8.47 %, Tier 1 risk-based capital ratio was 14.57% and Total risk-based capital ratio was 15.82% at December 31, 2010. These ratios exceed the minimum regulatory capital percentages of 4.0% for Tier 1 leverage ratio, 4.0% for Tier 1 risk-based capital ratio and 8.0% for Total risk-based capital ratio. Based on current regulatory standards, the Company is classified as "well capitalized."

### MARKET AND LIQUIDITY RISK MANAGEMENT

Management's objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies. The Bank's Asset Liability Management Committee ("ALCO") is charged with the responsibility of monitoring these policies, which are designed to ensure acceptable composition of asset/liability mix. Two critical areas of focus for ALCO are interest rate risk and liquidity risk management.

#### Interest Rate Risk Management

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates. The Company is subject to interest rate risk because assets and liabilities may mature or reprice at different times. For example, if liabilities reprice faster than assets, and interest rates are generally rising, earnings will initially decline. In addition, assets and liabilities may reprice at the same time but by different amounts. For example, when the general level of interest rates is rising, the Company may increase rates paid on interest bearing demand deposit accounts and savings deposit accounts by an amount that is less than the general increase in market interest rates. Also, short-term and long-term market interest rates may change by different amounts. For example, a flattening yield curve may reduce the interest spread between new loan yields and funding costs. Further, the remaining maturity of various assets and liabilities may shorten or lengthen as interest rates change. For example, if long-term mortgage interest rates decline sharply, mortgage-backed securities in the securities portfolio may prepay significantly earlier than anticipated, which could reduce earnings. Interest rates may also have a direct or indirect effect on loan demand, loan losses, mortgage origination volume, the fair value of MSRs and other items affecting earnings.

ALCO measures and evaluates the interest rate risk so that we can meet customer demands for various types of loans and deposits. ALCO determines the most appropriate amounts of on-balance sheet and off-balance sheet items. Measurements used to help manage interest rate sensitivity include an earnings simulation and an economic value of equity model.

**Earnings simulation.** Management believes that interest rate risk is best estimated by our earnings simulation modeling. On at least a quarterly basis, the following 12 month time period is simulated to determine a baseline net interest income forecast and the sensitivity of this forecast to changes in interest rates. The baseline forecast assumes an unchanged or flat interest rate environment. Forecasted levels of earning assets, interest-bearing liabilities, and off-balance sheet financial instruments are combined with ALCO forecasts of market interest rates for the next 12 months and other factors in order to produce various earnings simulations and estimates.

To limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income to less than a 10 percent decline for a 200 basis point gradual change up or down in rates from management's baseline net interest income forecast over the next twelve months. The following table reports the variance of net interest income over the next 12 months assuming a gradual change in interest rates of 200 basis points when compared to the baseline net interest income forecast at December 31, 2010.

Changes in Interest Rates	Net Interest Income % Variance
200 basis points	1.15%
(200) basis points	NM

NM=not meaningful

The impact of rate shock scenarios assuming a downward 200 basis point change in interest rates was not considered meaningful because of the historically low interest rate environment.

At December 31, 2010, our earnings simulation model results indicated a slightly asset-sensitive position over the next twelve months, which could serve to improve net interest income during that time period if interest rates increased by 200 basis points. The actual realized change in net interest income would depend upon several factors, which could also serve to diminish, or eliminate the asset sensitivity noted above.

**Economic Value of Equity.** Economic value of equity ("EVE") measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are estimated by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case EVE. In contrast with our earnings simulation model which evaluates interest rate risk over a 12 month timeframe, EVE uses a terminal horizon which allows for the repricing of all assets, liabilities, and off-balance sheet items. Further, EVE is measured using values as of a point in time and does not reflect any actions that ALCO might take in responding to or anticipating changes in interest rates, or market and competitive conditions.

To help limit interest rate risk, we have a guideline stating that for a 200 basis point instantaneous change in interest rates up or down, EVE should not decrease by more than 30 percent. The following table reports the variance of EVE assuming an immediate change in interest rates of 200 basis points when compared to the base case EVE at December 31, 2010.

Changes in Interest Rates	EVE % Variance
200 basis points	(30.56)%
(200) basis points	NM

NM=not meaningful

At December 31, 2010, the results of our EVE model would indicate that we are slightly above our Company guidelines. This slight variance results from a combination of factors, including a prolonged low interest rate environment in which a majority of our securities portfolio, which includes longer duration fixed-rate earning assets when compared to our loan portfolio, has repriced. The actual realized change in the economic value of equity would depend upon several factors, which could also serve to diminish, or eliminate the interest sensitivity noted above. Management is currently evaluating possible strategies that will bring the results of our EVE model within Company guidelines although no specific strategies have been proposed.

Earnings simulation and EVE are both modeling analyses, which change quarterly and consist of hypothetical estimates based upon numerous assumptions, including the interest rate levels, shape of the yield curve, prepayments on loans and securities, rates on loans and deposits, reinvestments of paydowns and maturities of loans, investments and deposits, and others. While assumptions are developed based on the current economic and market conditions, management cannot make any assurances as to the predictive nature of these assumptions, including how these estimates may be affected by customer preferences, competitors, or competitive conditions.

In addition, each of the preceding analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates, and other economic and market factors. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as "interest rate caps and floors") which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. Deposit and borrower behaviors also affect those relationships and results. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios in seeking satisfactory, consistent levels of profitability within the framework of the Company's established liquidity, loan, investment, borrowing, and capital policies.

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps ("swaps") to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2010 and 2009, the Company had no derivative contracts to assist in managing interest rate sensitivity.

### **Liquidity Risk Management**

Liquidity is the Company's ability to convert assets into cash equivalents in order to meet daily cash flow requirements, primarily for deposit withdrawals, loan demand and maturing obligations. Without proper management of its liquidity, the Company could experience higher costs of obtaining funds due to insufficient liquidity, while excessive liquidity can lead to a decline in earnings due to the cost of foregoing alternative higher-yielding investment opportunities.

Liquidity is managed at two levels. The first is the liquidity of the Company. The second is the liquidity of the Bank. The management of liquidity at both levels is essential, because the Company and the Bank have different funding needs and sources, are separate legal entities, and each are subject to regulatory guidelines and requirements.

The primary source of funding and the primary source of liquidity for the Company includes dividends received from the Bank, and secondarily proceeds from the issuance of common stock or other securities. Primary uses of funds for the Company include dividends paid to shareholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. The junior subordinated debentures are presented as long-term debt in the Consolidated Balance Sheets and the related trust preferred securities are includible in Tier 1 Capital for regulatory capital purposes.

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB's advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. As of December 31, 2010, the Bank had an available line of credit with the FHLB totaling \$232.4 million, with \$71.1 million outstanding. As of December 31, 2010, the Bank also had \$34.0 million of federal funds lines, with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.



The following table presents additional information about our contractual obligations as of December 31, 2010, which by their terms have contractual maturity and termination dates subsequent to December 31, 2010:

		Payments due by period			
(Dollars in thousands)	Total	1 year or less	1 to 3 years	3 to 5 years	More than 5 years
<b>Contractual obligations:</b>					
Deposit maturities (1)	\$607,127	301,014	210,286	55,145	40,682
Long-term debt	93,331	8,018	15,036	38,036	32,241
Operating lease obligations	783	332	363	88	—
Commitments to fund affordable housing investments	4,378	4,378	—	—	—
Total	\$705,619	313,742	225,685	93,269	72,923

(1) Deposits with no stated maturity (demand, NOW, money market, and savings deposits) are presented in the less than one year category.

Management believes that the Company and the Bank have adequate sources of liquidity to meet all known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next twelve months.

### Off-Balance Sheet Arrangements

At December 31, 2010, the Bank had outstanding standby letters of credit of \$7.8 million and unfunded loan commitments outstanding of \$41.7 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase federal funds from other financial institutions.

The Company also has commitments to fund certain affordable housing investments. The Company invests in various limited partnerships that sponsor affordable housing projects in its primary markets and surrounding areas as a means of supporting local communities. These investments are designed to generate a return primarily through the realization of federal tax credits. The Company typically provides financing during the construction and development of the properties; however, permanent financing is generally obtained from independent parties upon completion of a project. As of December 31, 2010, the Company had investments of \$3.4 million, related to these projects, which are included in other assets on the Consolidated Balance Sheets. Total unfunded commitments outstanding for affordable housing investments were \$4.4 million at December 31, 2010. When commitments to fund affordable housing investments are contingent upon a future event, a liability must be recognized when that contingent event becomes probable. As of December 31, 2010, the Company had \$1.9 million of unfunded commitments related to affordable housing investments included in other liabilities. Additionally, the Company had outstanding loan commitments with certain of the partnerships totaling \$11.4 million at December 31, 2010. The funded portion of these loans was approximately \$8.9 million at December 31, 2010. The funded portions of these loans are included in loans, net of unearned income on the Consolidated Balance Sheets.

The Company also makes various customary representations and warranties to the purchasers, including government agencies and government sponsored utilities such as Fannie Mae, of mortgage loans that the Company originates and sells in the secondary market. These representations and warranties may include, among other things:

- ownership of the loan;
- validity of the lien securing the loan;
- the absence of delinquent taxes or liens against the property;
- the process used to select the loan for inclusion in a transaction;
- the loan's compliance with any applicable loan criteria established by the buyer, including underwriting standards;
- delivery of all required documents to the trust; and
- the loan's compliance with applicable federal, state and local laws.

A breach of these presentations and warranties with respect to a particular mortgage loan or mortgage loans could result in the Company being required to repurchase the loan. During 2010 and 2009, no loans were repurchased by the Company. At December 31, 2010, no reserves have been deemed necessary for potential repurchase claims.

Management believes that the Company's foreclosure process related to mortgage loans continues to operate effectively, and reflects the Company's interest in these loans and their status appropriately. Foreclosures are approved by Senior Vice Presidents and Division Managers in concert with collection personnel. All documents and activities related to the foreclosure process are completed by the Company's outside attorneys.

### **Effects of Inflation and Changing Prices**

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with U.S. generally accepted accounting principles and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

### **CURRENT ACCOUNTING DEVELOPMENTS**

There are no current accounting pronouncements issued but not yet effective that would have a significant impact on the consolidated financial statements of the Company. See Note 1 to the consolidated financial statements that accompany this report for discussion of accounting standards adopted by the Company in 2010.

**Table 1 – Explanation of Non-GAAP Financial Measures**

In addition to results presented in accordance with U.S. generally accepted accounting principles (GAAP), this annual report on Form 10-K includes certain designated net interest income amounts presented on a tax-equivalent basis, a non-GAAP financial measure, including the presentation of total revenue and the calculation of the efficiency ratio.

The Company believes the presentation of net interest income on a tax-equivalent basis provides comparability of net interest income from both taxable and tax-exempt sources and facilitates comparability within the industry. Although the Company believes these non-GAAP financial measures enhance investors' understanding of its business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP. The reconciliation of these non-GAAP financial measures from GAAP to non-GAAP are presented below.

		2010				2009			
<i>(in thousands)</i>		Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Net interest income (GAAP)	\$	4,642	4,738	4,688	4,831	5,109	4,662	4,519	4,525
Tax-equivalent adjustment		441	449	438	437	438	432	404	359
Net interest income (Tax-equivalent)	\$	5,083	5,187	5,126	5,268	5,547	5,094	4,923	4,884

	Years ended December 31				
	2010	2009	2008	2007	2006
<i>(In thousands)</i>					
Net interest income (GAAP)	\$ 18,899	18,815	17,870	15,605	14,923
Tax-equivalent adjustment	1,765	1,633	1,361	1,123	1,033
Net interest income (Tax-equivalent)	\$ 20,664	20,448	19,231	16,728	15,956

Table 2 - Selected Financial Data

		Years ended December 31				
		2010	2009	2008	2007	2006
<i>(Dollars in thousands, except per share amounts)</i>						
<b>Income statement</b>						
Tax-equivalent interest income (a)	\$	35,237	38,467	39,722	38,670	35,601
Total interest expense		14,573	18,019	20,491	21,942	19,645
Tax equivalent net interest income (a)		20,664	20,448	19,231	16,728	15,956
Provision for loan losses		3,580	5,250	870	23	330
Total noninterest income		7,266	3,132	4,202	5,936	5,505
Total noninterest expense		16,441	14,633	12,542	12,360	11,201
Net earnings before income taxes and tax-equivalent adjustment		7,909	3,697	10,021	10,281	9,930
Tax-equivalent adjustment		1,765	1,633	1,361	1,123	1,033
Income tax expense (benefit)		798	(340)	2,023	2,240	2,312
Net earnings	\$	5,346	2,404	6,637	6,918	6,585
<b>Per share data:</b>						
Basic and diluted net earnings	\$	1.47	0.66	1.81	1.86	1.74
Cash dividends declared	\$	0.78	0.76	0.74	0.70	0.64
Weighted average shares outstanding						
Basic		3,642,851	3,644,691	3,674,384	3,716,427	3,777,721
Diluted		3,642,851	3,644,691	3,674,384	3,716,427	3,778,055
Shares outstanding		3,642,718	3,643,117	3,646,947	3,681,809	3,743,787
Book value	\$	15.47	15.42	15.66	14.40	12.93
Common stock price						
High	\$	22.00	30.00	25.00	30.00	28.89
Low		16.86	18.07	19.00	21.30	21.50
Period-end	\$	20.06	19.69	20.10	21.95	28.89
To earnings ratio		13.74x	29.39	11.10	11.80	16.60
To book value		130%	128	128	152	223
<b>Performance ratios:</b>						
Return on average equity		9.00%	4.23	12.18	13.50	14.66
Return on average assets		0.68%	0.31	0.92	1.06	1.06
Dividend payout ratio		53.06%	115.15	40.88	37.63	36.78
Average equity to average assets		7.61%	7.21	7.59	7.88	7.20
<b>Asset Quality:</b>						
Allowance for loan losses as a % of:						
Loans		2.05%	1.73	1.19	1.27	1.43
Nonperforming loans		65%	69	99	918	5,617
Nonperforming assets as a % of:						
Loans and foreclosed properties		5.22%	4.34	1.29	0.17	0.03
Total assets		2.61%	2.15	0.64	0.08	0.01
Nonperforming loans as % of loans		3.16%	2.49	1.20	0.14	0.03
Net charge-offs (recoveries) as a % of average loans		0.64%	0.84	0.17	(0.01)	0.05
<b>Capital Adequacy:</b>						
Tier 1 risk-based capital ratio		14.57%	13.73	14.23	15.09	15.59
Total risk-based capital ratio		15.82%	14.98	15.22	16.12	16.68
Tier 1 Leverage ratio		8.47%	8.13	8.75	9.02	9.22
<b>Other financial data:</b>						
Net interest margin (a)		2.86%	2.78	2.86	2.76	2.73
Effective income tax expense (benefit) rate		12.99%	(16.47)	23.36	24.46	25.99
Efficiency ratio (b)		58.87%	62.06	53.52	54.54	52.19
<b>Selected period end balances:</b>						
Securities	\$	315,220	334,762	302,656	318,373	301,937
Loans, net of unearned income		374,215	376,103	369,162	322,411	281,983
Allowance for loan losses		7,676	6,495	4,398	4,105	4,044
Total assets		763,829	773,382	745,970	688,659	635,126
Total deposits		607,127	579,409	550,843	492,585	469,648
Long-term debt		93,331	118,349	123,368	115,386	90,404
Total stockholders' equity		56,368	56,183	57,128	53,018	48,418

(a) Tax-equivalent. See "Table 1 - Explanation of Non-GAAP Financial Measures".

(b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

**Table 3 - Selected Quarterly Financial Data**

	2010				2009			
(Dollars in thousands, except per share amounts)	Fourth	Third	Second	First	Fourth	Third	Second	First
<b>Income statement</b>								
Tax-equivalent interest income (a)	\$ 8,423	8,819	8,899	9,096	9,570	9,610	9,652	9,635
Total interest expense	3,340	3,632	3,773	3,828	4,023	4,516	4,729	4,751
Tax equivalent net interest income (a)	5,083	5,187	5,126	5,268	5,547	5,094	4,923	4,884
Provision for loan losses	650	730	750	1,450	2,900	1,100	700	550
Total noninterest income (loss)	321	1,857	2,792	2,296	799	1,159	1,263	(89)
Total noninterest expense	3,630	4,366	4,809	3,636	3,735	3,421	3,924	3,553
Net earnings before income taxes and tax-equivalent adjustment	1,124	1,948	2,359	2,478	(289)	1,732	1,562	692
Tax-equivalent adjustment	441	449	438	437	438	432	404	359
Income tax (benefit) expense	(195)	255	314	424	(930)	277	226	87
Net earnings	\$ 878	1,244	1,607	1,617	203	1,023	932	246
<b>Per share data:</b>								
Basic and diluted net earnings	\$ 0.24	0.34	0.44	0.44	0.06	0.28	0.26	0.07
Cash dividends declared	\$ 0.195	0.195	0.195	0.195	0.19	0.190	0.190	0.190
Weighted average shares outstanding								
Basic and diluted	3,642,718	3,642,701	3,642,877	3,643,116	3,643,395	3,644,097	3,644,491	3,646,827
Shares outstanding, at period end	3,642,718	3,642,718	3,642,693	3,643,112	3,643,117	3,644,097	3,644,097	3,644,957
Book value	\$ 15.47	16.73	16.21	15.86	15.42	16.03	14.53	15.14
Common stock price								
High	\$ 22.00	22.00	21.00	21.95	25.98	29.99	30.00	26.40
Low	19.50	18.08	16.86	17.61	18.93	22.50	21.75	18.07
Period-end	\$ 20.06	20.35	18.80	20.65	19.69	24.40	28.50	21.00
To earnings ratio	13.74x	15.78	15.41	19.86	29.39	28.05	25.22	15.22
To book value	130%	122	116	130	128	152	196	139
<b>Performance ratios:</b>								
Return on average equity	5.68%	8.31	10.96	11.31	1.37	7.64	6.63	1.70
Return on average assets	0.45%	0.64	0.82	0.82	0.10	0.52	0.46	0.13
Dividend payout ratio	81.25%	57.35	44.32	44.32	316.67	67.86	73.08	271.43
Average equity to average assets	8.00%	7.68	7.47	7.30	7.63	6.78	7.00	7.45
<b>Asset Quality:</b>								
Allowance for loan losses as a % of:								
Loans	2.05%	1.91	1.75	1.72	1.73	1.42	1.24	1.21
Nonperforming loans	65%	82	72	60	69	64	720	100
Nonperforming assets as a % of:								
Loans and foreclosed properties	5.22%	4.42	4.05	4.65	4.34	3.52	1.53	1.24
Total assets	2.61%	2.18	1.98	2.28	2.15	1.75	0.72	0.58
Nonperforming loans as % of loans	3.16%	2.34	2.43	2.87	2.49	2.20	0.17	1.21
Net charge-offs as % of average loans	0.16%	0.14	0.76	1.48	1.95	0.31	0.63	0.45
<b>Capital Adequacy:</b>								
Tier 1 risk-based capital ratio	14.57%	14.53	14.25	13.76	13.73	13.70	13.81	13.77
Total risk-based capital ratio	15.82%	15.78	15.49	15.01	14.98	14.88	14.82	14.75
Tier 1 Leverage ratio	8.47%	8.39	8.27	8.17	8.13	8.05	7.89	8.10
<b>Other financial data:</b>								
Net interest margin (a)	2.81%	2.85	2.82	2.94	3.02	2.74	2.64	2.72
Effective income tax rate	NM%	17.01	16.35	20.77	NM	21.31	19.52	26.13
Efficiency ratio (b)	67.17%	61.98	60.74	48.07	58.86	54.71	63.43	74.10
<b>Selected period end balances:</b>								
Securities	\$ 315,220	322,118	333,107	333,660	334,762	338,924	349,472	358,425
Loans, net of unearned income	374,215	375,098	376,624	380,619	376,103	385,448	373,221	374,185
Allowance for loan losses	7,676	7,181	6,580	6,546	6,495	5,458	4,646	4,532
Total assets	763,829	777,846	784,124	791,324	773,382	786,042	800,910	802,450
Total deposits	607,127	602,508	605,755	608,588	579,409	597,591	616,442	609,206
Long-term debt	93,331	108,335	113,340	118,345	118,349	118,355	118,358	123,363
Total stockholders' equity	56,368	60,937	59,042	57,778	56,183	58,405	52,948	55,180

(a) Tax-equivalent. See "Table 1 - Explanation of Non-GAAP Financial Measures".

(b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

NM - not meaningful



Table 4 - Average Balance and Net Interest Income Analysis

	Years ended December 31								
	2010			2009			2008		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<i>(Dollars in thousands)</i>									
<b>Interest-earning assets:</b>									
Loans and loans held for sale (1)	\$ 380,552	\$ 21,809	5.73%	\$ 380,434	\$ 21,864	5.75%	\$ 347,176	\$ 22,447	6.47%
Securities - taxable	246,610	8,208	3.33%	269,266	11,775	4.37%	258,160	13,199	5.11%
Securities - tax-exempt (2)	81,256	5,190	6.39%	74,794	4,804	6.42%	62,801	4,001	6.37%
Total securities	327,866	13,398	4.09%	344,060	16,579	4.82%	320,961	17,200	5.36%
Federal funds sold	13,984	29	0.21%	10,138	23	0.23%	3,197	61	1.91%
Interest bearing bank deposits	1,076	1	0.09%	1,135	1	0.09%	511	14	2.74%
Total interest-earning assets	723,478	35,237	4.87%	735,767	38,467	5.23%	671,845	39,722	5.91%
Cash and due from banks	12,267			14,172			13,132		
Other assets	44,909			37,930			33,100		
Total assets	\$ 780,654			\$ 787,869			\$ 718,077		
<b>Interest-bearing liabilities:</b>									
Deposits:									
NOW	\$ 88,070	612	0.69%	\$ 90,794	859	0.95%	\$ 75,461	1,569	2.08%
Savings and money market	117,725	1,228	1.04%	93,484	1,054	1.13%	103,379	1,819	1.76%
Certificates of deposits less than \$100,000	113,912	2,758	2.42%	112,894	3,743	3.32%	95,830	4,147	4.33%
Certificates of deposits and other time deposits of \$100,000 or more	197,387	5,440	2.76%	221,028	7,483	3.39%	172,592	7,540	4.37%
Total interest-bearing deposits	517,094	10,038	1.94%	518,200	13,139	2.54%	447,262	15,075	3.37%
Short-term borrowings	3,530	23	0.65%	10,790	55	0.51%	16,604	324	1.95%
Long-term debt	112,312	4,512	4.02%	120,248	4,825	4.01%	123,108	5,092	4.14%
Total interest-bearing liabilities	632,936	14,573	2.30%	649,238	18,019	2.78%	586,974	20,491	3.49%
Noninterest-bearing deposits	84,837			78,244			72,914		
Other liabilities	3,468			3,580			3,715		
Stockholders' equity	59,414			56,807			54,474		
Total liabilities and stockholders' equity	\$ 780,654			\$ 787,869			\$ 718,077		
Net interest income and margin		\$ 20,664	2.86%		\$ 20,448	2.78%		\$ 19,231	2.86%

- (1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.
- (2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.

**Table 5 - Volume and Rate Variance Analysis**

	Years ended December 31, 2010 vs. 2009			Years ended December 31, 2009 vs. 2008		
	Net Change	Due to change in		Net Change	Due to change in	
(Dollars in thousands)		Rate (2)	Volume (2)		Rate (2)	Volume (2)
<b>Interest Income:</b>						
Loans and loans held for sale	\$ (55)	(62)	7	\$ (583)	(2,494)	1,911
Securities - taxable	(3,567)	(2,813)	(754)	(1,424)	(1,910)	486
Securities - tax-exempt (1)	386	(27)	413	803	33	770
Total securities	(3,181)	(2,840)	(341)	(621)	(1,877)	1,256
Federal funds sold	6	(2)	8	(38)	(54)	16
Interest bearing bank deposits	—	—	—	(13)	(14)	1
Total interest income	\$ (3,230)	(2,904)	(326)	\$ (1,255)	(4,439)	3,184
<b>Interest expense:</b>						
Deposits:						
NOW	\$ (247)	(228)	(19)	\$ (710)	(855)	145
Savings and money market	174	(79)	253	(765)	(654)	(111)
Certificates of deposits less than \$100,000	(985)	(1,009)	24	(404)	(970)	566
Certificates of deposits and other time deposits of \$100,000 or more	(2,043)	(1,392)	(651)	(57)	(1,697)	1,640
Total interest-bearing deposits	(3,101)	(2,708)	(393)	(1,936)	(4,176)	2,240
Short-term borrowings	(32)	15	(47)	(269)	(240)	(29)
Long-term debt	(313)	6	(319)	(267)	(153)	(114)
Total interest expense	(3,446)	(2,687)	(759)	(2,472)	(4,569)	2,097
Net interest income	\$ 216	(217)	433	\$ 1,217	130	1,087

- (1) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.
- (2) Changes that are not solely a result of volume or rate have been allocated to volume.

**Table 6 - Loan Portfolio Composition**

	December 31				
(In thousands)	2010	2009	2008	2007	2006
Commercial and industrial	\$ 53,288	53,884	53,883	50,797	45,702
Construction and land development	47,850	56,820	67,420	45,724	24,683
Commercial real estate	166,241	156,928	132,818	120,789	109,774
Residential real estate	96,241	97,407	102,835	93,888	92,830
Consumer installment	10,676	11,236	12,463	11,525	9,328
Total loans	374,296	376,275	369,419	322,723	282,317
Less: unearned income	(81)	(172)	(257)	(312)	(334)
Loans, net of unearned income	374,215	376,103	369,162	322,411	281,983
Less: allowance for loan losses	(7,676)	(6,495)	(4,398)	(4,105)	(4,044)
Loans, net	\$ 366,539	369,608	364,764	318,306	277,939

**Table 7 - Loan Maturities and Sensitivities to Changes in Interest Rates**

<i>(Dollars in thousands)</i>	December 31, 2010						
	1 year or less	1 to 5 years	After 5 years	Total	Adjustable Rate	Fixed Rate	Total
Commercial and industrial	\$ 5,993	42,184	5,111	53,288	\$ 31,378	21,910	53,288
Construction and land development	225	39,901	7,724	47,850	35,932	11,918	47,850
Commercial real estate	—	127,429	38,812	166,241	47,633	118,608	166,241
Residential real estate	395	35,571	60,275	96,241	53,828	42,413	96,241
Consumer installment	463	8,667	1,546	10,676	1,337	9,339	10,676
Total loans	\$ 7,076	253,752	113,468	374,296	\$ 170,108	204,188	374,296

Table 8 - Allowance for Loan Losses and Nonperforming Assets

	Years ended December 31				
<i>(Dollars in thousands)</i>	2010	2009	2008	2007	2006
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 6,495	4,398	4,105	4,044	3,843
Charge-offs:					
Commercial and industrial	(537)	(495)	(454)	(62)	(37)
Construction and land development	(1,487)	(2,088)	—	—	—
Commercial real estate	—	—	—	—	—
Residential real estate	(552)	(704)	(153)	(143)	(106)
Consumer installment	(111)	(61)	(98)	(45)	(46)
Total charge-offs	(2,687)	(3,348)	(705)	(250)	(189)
Recoveries:					
Commercial and industrial	63	47	102	14	13
Construction and land development	54	50	—	—	—
Commercial real estate	—	—	—	69	7
Residential real estate	151	92	6	199	4
Consumer installment	20	6	20	6	36
Total recoveries	288	195	128	288	60
Net (charge-offs) recoveries	(2,399)	(3,153)	(577)	38	(129)
Provision for loan losses	3,580	5,250	870	23	330
Ending balance	\$ 7,676	6,495	4,398	4,105	4,044
as a % of loans	2.05%	1.73	1.19	1.27	1.43
as a % of nonperforming loans	65%	69	99	918	5,617
Net charge-offs as a % of average loans	0.64%	0.84	0.17	(0.01)	0.05
<b>Nonperforming assets:</b>					
Nonaccrual/nonperforming loans	\$ 11,833	9,352	4,431	447	72
Other nonperforming assets (primarily other real estate owned)	8,125	7,292	324	98	—
Total nonperforming assets	\$ 19,958	16,644	4,755	545	72
as a % of loans and foreclosed properties	5.22%	4.34	1.29	0.17	0.03
as a % total assets	2.61%	2.15	0.64	0.08	0.01
Nonperforming loans as a % of total loans	3.16%	2.49	1.20	0.14	0.03
Accruing loans 90 days or more past due	\$ —	5	104	4	—



**Table 9 - Allocation of Allowance for Loan Losses**

	Years ended December 31									
	2010		2009		2008		2007		2006	
	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
<i>(Dollars in thousands)</i>										
Commercial and industrial	\$ 973	13.9	\$ 784	14.3	\$ 417	14.6	\$ 620	15.7	\$ 555	16.2
Construction and land development	2,223	12.5	2,063	15.1	873	18.3	613	14.2	360	8.7
Commercial real estate	2,893	43.4	1,264	41.7	1,175	36.0	1,237	37.4	1,367	38.9
Residential real estate	1,336	27.4	1,706	25.9	1,430	27.8	1,214	29.1	1,241	32.9
Consumer installment	141	2.8	227	3.0	166	3.4	118	3.6	91	3.3
Unallocated	110		451		337		303		430	
Total allowance for loan losses	\$ 7,676	100.0	\$ 6,495	100.0	\$ 4,398	100.0	\$ 4,105	100.0	\$ 4,044	100.0

\* Loan balance in each category expressed as a percentage of total loans.

**Table 10 - CDs and Other Time Deposits of \$100,000 or More***(Dollars in thousands)***December 31, 2010****Maturity of:**

3 months or less	\$	26,531
Over 3 months through 6 months		11,881
Over 6 months through 12 months		45,380
Over 12 months		106,485
Total CDs and other time deposits of \$100,000 or more <sup>(1)</sup>		\$ 190,277

<sup>(1)</sup> includes brokered certificates of deposit

### Management's Report on Internal Control Over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation and fair presentation of published financial statements. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Under the direction of the Company's Chief Executive Officer and Principal Financial and Accounting Officer, management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2010 in accordance with the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, management has concluded that such internal control over financial reporting was effective as of December 31, 2010.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to the final rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders  
Auburn National Bancorporation, Inc.:

We have audited the accompanying consolidated balance sheets of Auburn National Bancorporation, Inc. and subsidiaries (the Company) as of December 31, 2010 and 2009, and the related consolidated statements of earnings, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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 Auburn National Bancorporation, Inc. and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010 in conformity with U.S. generally accepted accounting principles.

**KPMG LLP**

Birmingham, Alabama  
March 29, 2011

**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Consolidated Balance Sheets**

	<b>December 31</b>	
	<b>2010</b>	<b>2009</b>
<i>(Dollars in thousands, except share data)</i>		
<b>Assets:</b>		
Cash and due from banks	\$ 11,432	\$ 11,567
Federal funds sold	7,500	—
Interest bearing bank deposits	2,492	828
Cash and cash equivalents	21,424	12,395
Securities available-for-sale	315,220	334,762
Loans held for sale	4,281	4,881
Loans, net of unearned income	374,215	376,103
Allowance for loan losses	(7,676)	(6,495)
Loans, net	366,539	369,608
Premises and equipment, net	8,105	8,282
Bank-owned life insurance	16,171	15,719
Other real estate owned	8,125	7,292
Other assets	23,964	20,443
Total assets	\$ 763,829	\$ 773,382
<b>Liabilities:</b>		
Deposits:		
Noninterest-bearing	\$ 87,660	\$ 76,497
Interest-bearing	519,467	502,912
Total deposits	607,127	579,409
Federal funds purchased and securities sold under agreements to repurchase	2,685	15,960
Long-term debt	93,331	118,349
Accrued expenses and other liabilities	4,318	3,481
Total liabilities	707,461	717,199
<b>Stockholders' equity:</b>		
Preferred stock of \$.01 par value; authorized 200,000 shares; issued shares - none	—	—
Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,752	3,751
Retained earnings	61,421	58,917
Accumulated other comprehensive (loss) income, net	(2,201)	111
Less treasury stock, at cost - 314,417 shares and 314,018 shares for December 31, 2010 and 2009, respectively	(6,643)	(6,635)
Total stockholders' equity	56,368	56,183
Total liabilities and stockholders' equity	\$ 763,829	\$ 773,382

*See accompanying notes to consolidated financial statements*



**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Earnings**

	Years ended December 31		
	2010	2009	2008
<i>(Dollars in thousands, except share and per share data)</i>			
<b>Interest income:</b>			
Loans, including fees	\$ 21,809	\$ 21,864	\$ 22,447
Securities	11,633	14,946	15,839
Federal funds sold and interest bearing bank deposits	30	24	75
Total interest income	33,472	36,834	38,361
<b>Interest expense:</b>			
Deposits	10,038	13,139	15,075
Short-term borrowings	23	55	324
Long-term debt	4,512	4,825	5,092
Total interest expense	14,573	18,019	20,491
<b>Net interest income</b>	18,899	18,815	17,870
<b>Provision for loan losses</b>	3,580	5,250	870
<b>Net interest income after provision for loan losses</b>	15,319	13,565	17,000
<b>Noninterest income:</b>			
Service charges on deposit accounts	1,280	1,243	1,252
Mortgage lending	3,042	4,048	1,694
Bank-owned life insurance	452	424	470
Other	1,069	1,120	1,954
Securities gains (losses), net			
Realized gains, net	3,451	2,847	357
Total other-than-temporary impairments	(2,238)	(6,807)	(1,525)
Non-credit portion of other-than-temporary impairments recognized in other comprehensive income	210	257	—
Total securities gains (losses), net	1,423	(3,703)	(1,168)
Total noninterest income	7,266	3,132	4,202
<b>Noninterest expense:</b>			
Salaries and benefits	7,950	7,819	7,278
Net occupancy and equipment	1,450	1,500	1,314
Professional fees	702	799	511
FDIC and other regulatory assessments	1,092	1,322	358
Other real estate owned, net	1,378	43	67
Prepayment penalty on long-term debt	679	—	—
Other	3,190	3,150	3,014
Total noninterest expense	16,441	14,633	12,542
<b>Earnings before income taxes</b>	6,144	2,064	8,660
<b>Income tax expense (benefit)</b>	798	(340)	2,023
<b>Net earnings</b>	\$ 5,346	\$ 2,404	\$ 6,637
<b>Net earnings per share:</b>			
Basic and diluted	\$ 1.47	\$ 0.66	\$ 1.81
<b>Weighted average shares outstanding:</b>			
Basic and diluted	3,642,851	3,644,691	3,674,384

See accompanying notes to consolidated financial statements

**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Stockholders' Equity and Comprehensive Income**

<i>(Dollars in thousands, except share and per share data)</i>	Common Stock		Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
	Shares	Amount					
<b>Balance, December 31, 2007</b>	3,957,135	\$ 39	\$ 3,748	\$ 55,362	\$ (397)	\$ (5,734)	\$ 53,018
Comprehensive income:							
Net earnings	—	—	—	6,637	—	—	6,637
Other comprehensive income due to change in unrealized gain on securities available for sale, net	—	—	—	—	1,000	—	1,000
Total comprehensive income	—	—	—	6,637	1,000	—	7,637
Cash dividends paid (\$0.74 per share)	—	—	—	(2,716)	—	—	(2,716)
Stock repurchases (34,932 shares)	—	—	—	—	—	(813)	(813)
Sale of treasury stock (70 shares)	—	—	1	—	—	1	2
<b>Balance, December 31, 2008</b>	3,957,135	\$ 39	\$ 3,749	\$ 59,283	\$ 603	\$ (6,546)	\$ 57,128
Comprehensive income:							
Net earnings	—	—	—	2,404	—	—	2,404
Other comprehensive loss due to change in other-than-temporary impairment losses related to factors other than credit on available-for- sale, net	—	—	—	—	(162)	—	(162)
Other comprehensive loss due to change in unrealized loss on securities available for sale, net	—	—	—	—	(330)	—	(330)
Total comprehensive income	—	—	—	2,404	(492)	—	1,912
Cash dividends paid (\$0.76 per share)	—	—	—	(2,770)	—	—	(2,770)
Stock repurchases (3,955 shares)	—	—	—	—	—	(90)	(90)
Sale of treasury stock (125 shares)	—	—	2	—	—	1	3
<b>Balance, December 31, 2009</b>	3,957,135	\$ 39	\$ 3,751	\$ 58,917	\$ 111	\$ (6,635)	\$ 56,183
Comprehensive income:							
Net earnings	—	—	—	5,346	—	—	5,346
Other comprehensive loss due to change in other-than-temporary impairment losses related to factors other than credit on available-for- sale, net	—	—	—	—	(133)	—	(133)
Other comprehensive loss due to change in unrealized loss on securities available for sale, net	—	—	—	—	(2,179)	—	(2,179)
Total comprehensive income	—	—	—	5,346	(2,312)	—	3,034
Cash dividends paid (\$0.78 per share)	—	—	—	(2,842)	—	—	(2,842)
Stock repurchases (484 shares)	—	—	—	—	—	(9)	(9)
Sale of treasury stock (85 shares)	—	—	1	—	—	1	2
<b>Balance, December 31, 2010</b>	3,957,135	\$ 39	\$ 3,752	\$ 61,421	\$ (2,201)	\$ (6,643)	\$ 56,368

*See accompanying notes to consolidated financial statements*

## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(In thousands)	Years ended December 31		
	2010	2009	2008
<b>Cash flows from operating activities:</b>			
Net earnings	\$ 5,346	\$ 2,404	\$ 6,637
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	3,580	5,250	870
Depreciation and amortization	902	705	1,052
Premium amortization and discount accretion, net	2,071	1,562	5
Deferred tax benefit	(777)	(2,190)	(668)
Net (gain) loss on securities available for sale	(1,423)	1,723	1,168
Net gain on sale of loans held for sale	(2,691)	(3,701)	(606)
Net loss on nonmarketable equity investments	—	1,980	—
Net loss (gain) on other real estate owned	1,217	(64)	8
Loans originated for sale	(100,721)	(157,041)	(79,947)
Proceeds from sale of loans	103,488	158,766	79,712
Net loss (gain) on disposition of premises and equipment	4	—	(1,064)
Increase in cash surrender value of bank owned life insurance	(452)	(424)	(470)
Loss on prepayment of long-term debt	679	—	—
Net increase in other assets	(1,677)	(4,409)	(979)
Net increase (decrease) in accrued expenses and other liabilities	837	(240)	298
Net cash provided by operating activities	10,383	4,321	6,016
<b>Cash flows from investing activities:</b>			
Proceeds from sales of securities available-for-sale	180,206	146,966	67,431
Proceeds from maturities and calls of securities available-for-sale	194,570	105,497	67,933
Purchase of securities available-for-sale	(359,547)	(288,633)	(119,202)
Net increase in loans	(3,221)	(17,593)	(47,975)
Net purchases of premises and equipment	(146)	(824)	(2,210)
Proceeds from the sale of premises and equipment	—	—	1,606
Proceeds from sale of other real estate owned	660	724	412
Improvements to other real estate owned	—	(129)	—
Net decrease (increase) in FHLB stock	227	(107)	(452)
Net cash provided by (used in) investing activities	12,749	(54,099)	(32,457)
<b>Cash flows from financing activities:</b>			
Net increase (decrease) in noninterest-bearing deposits	11,163	(1,516)	7,772
Net increase in interest-bearing deposits	16,555	30,082	50,486
Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase	(13,275)	5,050	(13,337)
Proceeds from issuance of long-term debt	—	—	18,000
Repayments or retirement of long-term debt	(25,697)	(5,019)	(10,018)
Stock repurchases	(9)	(90)	(813)
Proceeds from sale of treasury stock	2	3	2
Dividends paid	(2,842)	(2,770)	(2,716)
Net cash (used in) provided by financing activities	(14,103)	25,740	49,376
Net change in cash and cash equivalents	9,029	(24,038)	22,935
Cash and cash equivalents at beginning of period	12,395	36,433	13,498
<b>Cash and cash equivalents at end of period</b>	<b>\$ 21,424</b>	<b>\$ 12,395</b>	<b>\$ 36,433</b>
<b>Supplemental disclosures of cash flow information:</b>			
Cash paid during the period for:			
Interest	\$ 15,044	\$ 18,560	\$ 20,551
Income taxes	2,113	1,830	3,068
<b>Supplemental disclosure of non-cash transactions:</b>			
Real estate acquired through foreclosure	2,710	7,499	647

See accompanying notes to consolidated financial statements

## **NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **Nature of Business**

Auburn National Bancorporation, Inc. (the “Company”) is a bank holding company whose primary business is conducted by its wholly-owned subsidiary, AuburnBank (the “Bank”). AuburnBank is a commercial bank located in Auburn, Alabama. The Bank provides a full range of banking services in its primary market area, Lee County, which includes the Auburn-Opelika Metropolitan Statistical Area.

### **Basis of Presentation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, AuburnBank. Significant intercompany transactions are eliminated in consolidation.

### **Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the balance sheet date and the reported amounts of income and expense during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses, fair value measurements, valuation of other real estate owned, and valuation of deferred tax assets.

### **Correction of Accounting Errors**

Income tax benefit for the year ended December 31, 2009 included a \$281 thousand tax benefit related to the correction of an error in prior periods that resulted from the incorrect calculation of tax basis for certain available-for-sale securities, primarily related to periods prior to January 1, 2007. Other noninterest income for the year ended December 31, 2008 included a \$452 thousand pre-tax charge (\$285 thousand after-tax) related to the correction of an error in prior periods that resulted from the incorrect application of the equity method of accounting for an investment in an affordable housing limited partnership, primarily related to the years ended December 31, 2005, 2006 and 2007. Management believes the impact of these corrections are not material to current or prior period financial statements and the Company’s Audit Committee of the Board of Directors, based on information reviewed by management with the Audit Committee, concurs with management’s conclusion.

### **Reclassifications**

Certain amounts reported in prior periods have been reclassified to conform to the current-period presentation. These reclassifications had no effect on the Company’s previously reported net earnings or total stockholders’ equity.

### **Accounting Standards Adopted in 2010**

In the first quarter of 2010, the Company adopted new guidance related to the following Codification topics:

- Accounting Standards Update (“ASU”) 2009-16, *Accounting for Transfers of Financial Assets*;
- ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest*;
- ASU 2010-06, *Improving Disclosures about Fair Value Measurements*; and
- ASU 2010-10, *Consolidation: Amendments for Certain Investment Funds*.

In the third quarter of 2010, the Company adopted new guidance related to the following Codification topic:

- ASU 2010-11, *Derivatives and Hedging: Scope Exception Related to Embedded Credit Derivatives*.

In the fourth quarter of 2010, the company adopted new guidance related to the following Codification topics:

- ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*; and
- ASU 2011-01, *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update*.

Information about these pronouncements is described in more detail below.

ASU 2009-16, *Accounting for Transfers of Financial Assets*, modifies certain guidance contained in FASB Accounting Standards Codification (“ASC”) 860, *Transfers and Servicing*. This standard eliminates the concept of qualifying special purpose entities (QSPEs) and provides additional criteria transferors must use to evaluate transfers of financial assets. To determine if a transfer is to be accounted for as a sale, the transferor must assess whether it and all of the entities included in its consolidated financial statements have surrendered control of the assets. A transferor must consider all arrangements or agreements made or contemplated at the time of transfer before reaching a conclusion on whether control has been relinquished. The standard also addresses situations in which a portion of a financial asset is transferred. In such instances the transfer can only be accounted for as a sale when the transferred portion is considered to be a participating interest, as defined, and also requires that any assets or liabilities retained from a transfer accounted for as a sale be initially recognized at fair value. This standard was effective for the Company as of January 1, 2010, with adoption applied prospectively for transfers that occur on and after the effective date. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company.

ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, amends several key consolidation provisions related to variable interest entities (“VIEs”), which are included in FASB ASC 810, *Consolidation*. First, the scope of the standard includes entities that are currently designated as QSPEs. Second, the standard changes the approach companies use to identify the VIEs for which they are deemed to be the primary beneficiary and are required to consolidate. Under the former rules, the primary beneficiary is the entity that absorbs the majority of a VIE’s losses and receives the majority of the VIE’s returns. The new guidance identifies a VIE’s primary beneficiary as the entity that has the power to direct the VIE’s significant activities that effect the economic performance of the entity, and has an obligation to absorb losses or the right to receive benefits that could be potentially significant to the VIE. Third, the standard requires companies to continually reassess whether they are the primary beneficiary of a VIE. The former rules only require companies to reconsider primary beneficiary conclusions when certain triggering events have occurred. The standard was effective for the Company as of January 1, 2010, and applies to all current QSPEs and VIEs, and VIEs created after the effective date. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company.

ASU 2010-6, *Improving Disclosures about Fair Value Measurements*, amends AS 820, *Fair Value Measurements and Disclosures*. ASU 2010-6 requires expanded disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (ii) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. ASU 2010-6 further clarifies that (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) companies should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy will be required for the Company beginning January 1, 2011. The remaining disclosure requirements and clarifications in ASU 2010-06 became effective for the Company on January 1, 2010. Adoption did not affect the Company’s consolidated financial results, since it amended only the disclosure requirements for fair value measurements. See Note 16 of the Consolidated Financial Statements.

ASU 2010-10, *Consolidation: Amendments for Certain Investment Funds*, which defers, for certain investment funds, the consolidation requirements resulting from the issuance of ASU 2009-17. Specifically, the deferral is applicable for a reporting entity’s interest in an entity (1) that has all the attributes of an investment company or (2) for which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those followed by investment companies. ASU 2010-10 was effective for periods beginning after November 15, 2009. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company.



ASU 2010-11, *Derivatives and Hedging: Scope Exception Related to Embedded Credit Derivatives*, amends and clarifies the accounting for credit derivatives embedded in interests in securitized financial assets. ASU 2010-11 amends ASC 815 to provide clarifying language and examples of when an embedded credit derivative's features are not considered "embedded derivatives subject to potential bifurcation and separate accounting". The guidance was effective for the Company beginning in the third quarter 2010. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company.

ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, requires enhanced disclosures for the allowance for credit losses and financing receivables, which include certain loans and long-term accounts receivable. Companies will be required to disaggregate credit quality information, including receivables on nonaccrual status, aging of past due receivables, and the roll forward of the allowance for credit losses, by portfolio segment or class of financing receivable. Portfolio segment is the level at which an entity evaluates credit risk and determines its allowance for credit losses, and class of financing receivable is generally a lower level of portfolio segment. This guidance was effective for the Company in the fourth quarter of 2010 with prospective application. Companies must also provide more granular information on the nature and extent of TDRs and their effect on the allowance for credit losses. Under ASU 2011-01, *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*, these TDR disclosures have been deferred to coincide with a separate FASB TDR project, with an expected effective date in second quarter 2011. Adoption of this standard did not affect the Company's consolidated financial results, since it amended only the disclosure requirements for the allowance for loan losses. See Note 5 of the Consolidated Financial Statements.

### **Cash Equivalents**

Cash on hand, cash items in process of collection, amounts due from banks, and federal funds sold are included in cash and cash equivalents.

### **Securities**

Securities are classified based on management's intention at the date of purchase. At December 31, 2010, all of the Company's securities were classified as available-for-sale. Securities available-for-sale are used as part of the Company's interest rate risk management strategy, and they may be sold in response to changes in interest rates, changes in prepayment risks or other factors. All securities classified as available-for-sale are recorded at fair value with any unrealized gains and losses reported in accumulated other comprehensive loss, net of the deferred income tax effects. Interest and dividends on securities, including the amortization of premiums and accretion of discounts are calculated using a method that approximates the effective interest method over the anticipated life of the security, taking into consideration prepayment assumptions. Realized gains and losses from the sale of securities are determined using the specific identification method.

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses).

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the entity will be required to sell the debt security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings, as a realized loss in securities gains (losses), and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

**Loans held for sale**

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value as determined on an aggregated basis. Estimated fair value is determined on the basis of existing commitments or the current market value of similar loans. Loan sales are recognized when the transaction closes, the proceeds are collected, and ownership is transferred. Continuing involvement, through the sales agreement, consists of the right to service the loan for a fee for the life of the loan, if applicable. Gains on the sale of loans held for sale are recorded as part of mortgage lending income in the Consolidated Statements of Earnings.

In the course of conducting the Company's mortgage lending activities of originating mortgage loans and selling those loans in the secondary market, various representations and warranties are made to the purchaser of the mortgage loans. Every loan closed by the Bank's mortgage center is run through a government agency automated underwriting system. Any exceptions noted during this process are remedied prior to sale. These representations and warranties also apply to underwriting the real estate appraisal opinion of value for the collateral securing these loans. Under the representations and warranties, failure by the Company to comply with the underwriting and/or appraisal standards could result in the Company being required to repurchase the mortgage loan or to reimburse the investor for losses incurred (make whole requests) if such failure cannot be cured by the Company within the specified period following discovery. During 2010, no loans were repurchased and no reimbursements for investor losses were made by the Company.

**Loans**

Loans are reported at their outstanding principal balances, net of any unearned income, charge-offs, and any deferred fees or costs on originated loans. Interest income is accrued based on the principal balance outstanding. Loan origination fees, net of certain loan origination costs, are deferred and recognized as an adjustment to the related loan yield using a method that approximates the interest method. Loan commitment fees are generally deferred and amortized on a straight-line basis over the commitment period, which results in a recorded amount that approximates fair value.

The accrual of interest on loans is discontinued when there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or the principal or interest is more than 90 days past due, unless the loan is both well-collateralized and in the process of collection. Generally, all interest accrued but not collected for loans that are placed on nonaccrual status are reversed against current interest income. Interest collections on nonaccrual loans are generally applied as principal reductions. The Company determines past due or delinquency status of a loan based on contractual payment terms.

A loan is considered impaired when it is probable the Company will be unable to collect all principal and interest payments due according to the contractual terms of the loan agreement. Individually identified impaired loans are measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. If the recorded investment in the impaired loan exceeds the measure of fair value, a valuation allowance may be established as part of the allowance for loan losses. Changes to the valuation allowance are recorded as a component of the provision for loan losses.

Impaired loans also included troubled debt restructurings ("TDRs"). In the normal course of business, management grants concessions to borrowers, which would not otherwise be considered, where the borrowers are experiencing financial difficulty. The concessions granted most frequently for TDRs involve reductions or delays in required payments of principal and interest for a specified time, the rescheduling of payments in accordance with a bankruptcy plan or the charge-off of a portion of the loan. In most cases, the conditions of the credit also warrant nonaccrual status, even after the restructure occurs. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructure. TDR loans may be returned to accrual status if there has been at least a six-month sustained period of repayment performance by the borrower.

**Allowance for Loan Losses**

The allowance for loan losses is maintained at a level that management believes is adequate to absorb probable losses inherent in the loan portfolio. Loan losses are charged against the allowance when they are known. Subsequent recoveries are credited to the allowance. Management's determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, growth, composition of the loan portfolio, homogeneous pools of loans, risk ratings of specific loans, historical loan loss factors, identified impaired loans and other factors related to the portfolio. This evaluation is performed quarterly and is inherently subjective, as it requires various material estimates that are susceptible to significant change, including the amounts and timing of future cash flows expected to be received on any impaired loans. In addition, regulatory agencies, as an integral part of their examination process, will periodically review the Company's allowance for loan losses, and may require the Company to record additions to the allowance based on their judgment about information available to them at the time of their examinations.

## **Premises and Equipment**

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation computed on a straight-line method over the useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured.

## **Other Real Estate Owned**

Other real estate owned ("OREO") includes properties acquired through, or in lieu of, loan foreclosure that are held for sale and are initially recorded at the lower of the loan's carrying amount or fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying value amount or fair value less cost to sell. Gains or losses realized upon sale of OREO and additional losses related to subsequent valuation adjustments are determined on a specific property basis and are included as a component of Other real estate owned, net, within noninterest expense.

## **Nonmarketable equity investments**

Nonmarketable equity investments include equity securities that are not publicly traded and securities acquired for various purposes. The Bank is required to maintain certain minimum levels of equity investments with certain regulatory and other entities in which the Bank has an ongoing business relationship based on the common stock and surplus (Federal Reserve Bank) or outstanding borrowings (Federal Home Loan Bank of Atlanta) of the Bank. These securities are accounted for under the cost method and are included in other assets. For cost-method investments, on a quarterly basis, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment. If the Company determines that a decline in value is other-than-temporary, the Company will recognize the estimated loss in securities gains (losses), net.

## **Transfers of Financial Assets**

Transfers of an entire financial asset (i.e. loan sales), a group of entire financial assets, or a participating interest in an entire financial asset (i.e. loan participations sold) are accounted for as sales when control over the assets have been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

## **Mortgage Servicing Rights**

The Company recognizes as assets the rights to service mortgage loans for others, known as MSR's. The Company determines the fair value of MSR's at the date the loan is transferred. To determine the fair value of MSR's, the Company engages an independent third party. The independent third party's valuation model calculates the present value of estimated future net servicing income using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees.

Subsequent to the date of transfer, the Company has elected to measure its MSR's under the amortization method. Under the amortization method, MSR's are amortized in proportion to, and over the period of, estimated net servicing income. The amortization of MSR's is analyzed monthly and is adjusted to reflect changes in prepayment speeds, as well as other factors. MSR's are evaluated for impairment based on the fair value of those assets. Impairment is determined by stratifying MSR's into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSR's exceeds fair value, a valuation reserve is established through a charge to earnings. The valuation reserve is adjusted as the fair value changes. MSR's are included in the other assets category in the accompanying consolidated balance sheets.

## **Derivative Instruments**

In accordance with FASB ASC Topic 815, *Derivatives and Hedging*, all derivative instruments are recorded on the consolidated balance sheet at their respective fair values.

The accounting for changes in fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. If the derivative instrument is not designated as part of a hedging relationship, the gain or loss on the derivative instrument is recognized in earnings in the period of change. None of the derivatives utilized by the Company have been designated as a hedge.

**Securities sold under agreements to repurchase**

Securities sold under agreements to repurchase generally mature less than one year from the transaction date. Securities sold under agreements to repurchase are reflected as a secured borrowing in the accompanying consolidated balance sheets at the amount of cash received in connection with each transaction.

**Income Taxes**

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. The net deferred tax asset is reflected as a component of Other Assets on the Consolidated Balance Sheets.

Income tax expense or benefit for the year is allocated among continuing operations and other comprehensive income (loss), as applicable. The amount allocated to continuing operations is the income tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (1) changes in certain circumstances that cause a change in judgment about the realization of deferred tax assets in future years, (2) changes in income tax laws or rates, and (3) changes in income tax status, subject to certain exceptions. The amount allocated to other comprehensive income (loss) is related solely to changes in the valuation allowance on items that are normally accounted for in other comprehensive income (loss) such as unrealized gains or losses on available-for-sale securities.

In accordance with ASC 740, a tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. The adoption had no material effect on the Company’s financial statements. It is the Company’s policy to recognize interest and penalties related to income tax matters in income tax expense. The Company and its wholly-owned subsidiary file a consolidated income tax return.

**Fair Value Measurements**

FASB ASC 820, which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. ASC 820 applies only to fair-value measurements that are already required or permitted by other accounting standards. The definition of fair value focuses on the exit price, i.e., 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, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. For more information related to fair value measurements, please refer to Note 16.

**Subsequent Events**

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to December 31, 2010. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

**Earnings Per Share**

Basic net earnings per share are computed by dividing net earnings by the weighted average common shares outstanding for the year. Diluted net earnings per share reflect the potential dilution that could occur if the Company’s potential common stock was issued. As of December 31, 2010, 2009 and 2008, the Company had no options issued or outstanding and therefore no dilutive effect to consider for the diluted earnings per share calculation.

A reconciliation of the numerator and denominator of the basic and diluted earnings per share computation for the years ended December 31, 2010, 2009 and 2008, respectively, is presented below.

	Years ended December 31		
	2010	2009	2008
<i>(Dollars in thousands, except share and per share data)</i>			
<b>Basic and diluted:</b>			
Net earnings	\$ 5,346	\$ 2,404	\$ 6,637
Average common shares outstanding	3,642,851	3,644,691	3,674,384
Earnings per share	\$ 1.47	\$ 0.66	\$ 1.81

## NOTE 2: VARIABLE INTEREST ENTITIES

The Company is involved in various entities that are considered to be VIEs, as defined by authoritative accounting literature. Generally, a VIE is a corporation, partnership, trust or other legal structure that does not have equity investors with substantive or proportional voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities.

At December 31, 2010, the Company did not have any consolidated VIEs to disclose but did have certain nonconsolidated VIEs, discussed below.

### Trust Preferred Securities

The Company owns the common stock of a subsidiary business trust, Auburn National Bancorporation Capital Trust I, which issued mandatorily redeemable preferred capital securities ("trust preferred securities") in the aggregate of approximately \$7.0 million at the time of issuance. This trust meets the definition of a VIE of which the Company is not the primary beneficiary; the trust's only assets are junior subordinated debentures issued by the Company, which were acquired by the trust using the proceeds from the issuance of the trust preferred securities and common stock. The junior subordinated debentures of approximately \$7.2 million are included in long-term debt and the Company's equity interest in the business trust is included in other assets. Interest expense on the junior subordinated debentures is reported in interest expense on long-term debt. For regulatory reporting and capital adequacy purposes, the Federal Reserve Board has indicated that such trust preferred securities will continue to constitute Tier 1 Capital until further notice.

### Affordable Housing Investments

Periodically, the Company may invest in various limited partnerships that sponsor affordable housing projects in its primary markets and surrounding areas as a means of supporting local communities. These investments are designed to generate a return primarily through the realization of federal tax credits. These projects are funded through a combination of debt and equity and the partnerships meet the definition of a VIE. While the Company's investment as a limited partner in a single entity may at times exceed 50% of the outstanding equity interests, the Company does not consolidate the partnerships due to the nature of the management activities of the general partner and the performance guaranties provided by the project sponsors giving them the majority of the variability.

The Company typically provides financing during the construction and development of the properties; however, permanent financing is generally obtained from independent parties upon completion of a project. As of December 31, 2010 and 2009, the Company had limited partnership investments of \$3.4 million and \$0.3 million, respectively, related to these projects, which are included in Other assets on the Consolidated Balance Sheets.

When commitments to fund affordable housing investments are contingent upon a future event, a liability must be recognized when that contingent event becomes probable. At December 31, 2010, total unfunded commitments outstanding for affordable housing investments were \$4.4 million, of which \$1.9 million was included in other liabilities. At December 31, 2009, the Company had no unfunded commitments related to affordable housing investments.

Additionally, the Company had outstanding loan commitments with certain of the partnerships totaling \$11.4 million at December 31, 2010 and 2009, respectively. The funded portion of these loans was approximately \$8.9 million at December 31, 2010. There was no funded portion for any of the outstanding loan commitments with certain of the partnerships at December 31, 2009. The funded portions of these loans are included in loans, net of unearned income on the Consolidated Balance Sheets.



The following table summarizes VIEs that are not consolidated by the Company as of December 31, 2010.

<i>(Dollars in thousands)</i>	<b>Maximum Loss Exposure</b>	<b>Liability Recognized</b>	<b>Classification</b>
<b>Type:</b>			
Affordable housing investments (a)	\$ 5,877	\$ 1,871	Other assets
Trust preferred issuances	N/A	7,217	Long-term debt

- (a) Maximum loss exposure represents \$3.4 million of current investments and \$2.5 million of contractual funding commitments contingent upon future events. The current investment of \$3.4 million includes undisbursed equity contributions of \$1.9 million the Company was contractually obligated to pay at December 31, 2010. The accrued commitment amount was included in other liabilities.

### NOTE 3: RESTRICTED CASH BALANCES

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. At December 31, 2010 and 2009, the Bank did not have a required reserve balance at the Federal Reserve Bank.

### NOTE 4: SECURITIES

At December 31, 2010 and 2009, respectively, all securities within the scope of FASB ASC 320, *Investments – Debt and Equity Securities* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at December 31, 2010 and 2009, respectively, are presented below.

<i>(Dollars in thousands)</i>	<b>December 31, 2010</b>							
	<b>1 year or less</b>	<b>1 to 5 years</b>	<b>5 to 10 years</b>	<b>After 10 years</b>	<b>Fair Value</b>	<b>Gross Unrealized</b>		<b>Amortized cost</b>
						<b>Gains</b>	<b>Losses</b>	
<b>Available-for-sale:</b>								
Agency obligations (a)	\$ —	—	37,821	52,650	90,471	95	1,017	91,393
Agency RMBS (a)	—	—	9,976	133,168	143,144	1,566	1,441	143,019
State and political subdivisions	21	856	13,547	62,342	76,766	472	2,801	79,095
Trust preferred securities:								
Pooled	—	—	—	20	20	—	210	230
Individual issuer	—	—	—	2,129	2,129	—	153	2,282
Corporate debt	—	2,690	—	—	2,690	—	—	2,690
<b>Total available-for-sale</b>	<b>\$ 21</b>	<b>3,546</b>	<b>61,344</b>	<b>250,309</b>	<b>315,220</b>	<b>2,133</b>	<b>5,622</b>	<b>318,709</b>

- (a) Includes securities issued by U.S. government agencies or government sponsored entities.

<i>(Dollars in thousands)</i>	<b>December 31, 2009</b>							
	<b>1 year or less</b>	<b>1 to 5 years</b>	<b>5 to 10 years</b>	<b>After 10 years</b>	<b>Fair Value</b>	<b>Gross Unrealized</b>		<b>Amortized cost</b>
						<b>Gains</b>	<b>Losses</b>	
<b>Available-for-sale:</b>								
Agency obligations (a)	\$ —	—	42,626	47,594	90,220	363	630	90,487
Agency RMBS (a)	—	—	5,261	153,381	158,642	3,264	380	155,758
State and political subdivisions	—	382	16,073	65,107	81,562	1,031	578	81,109
Trust preferred securities:								
Pooled	—	—	—	23	23	—	257	280
Individual issuer	—	—	—	1,440	1,440	—	2,010	3,450
Corporate debt	—	2,142	733	—	2,875	—	626	3,501
<b>Total available-for-sale</b>	<b>\$ —</b>	<b>2,524</b>	<b>64,693</b>	<b>267,545</b>	<b>334,762</b>	<b>4,658</b>	<b>4,481</b>	<b>334,585</b>

- (a) Includes securities issued by U.S. government agencies or government sponsored entities.

Securities with aggregate fair values of \$171.1 million and \$203.4 million at December 31, 2010 and 2009, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (“FHLB”) advances, and for other purposes required or permitted by law.

Included in Other assets in the Consolidated Balance Sheets are cost-method investments. The carrying amounts of cost-method investments were \$5.8 million and \$6.0 million at December 31, 2010 and 2009, respectively. Cost-method investments primarily include nonmarketable equity investments, such as Federal Home Loan Bank (“FHLB”) of Atlanta stock and Federal Reserve Bank stock.

### Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at December 31, 2010 and 2009, respectively, segregated by those securities that have been in an unrealized loss position for less than twelve months and twelve months or more are presented below.

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>(Dollars in thousands)</i>						
<b>December 31, 2010:</b>						
Agency obligations	\$ 45,351	1,017	—	—	45,351	1,017
Agency RMBS	89,840	1,441	—	—	89,840	1,441
State and political subdivisions	49,176	2,323	3,207	478	52,383	2,801
Trust preferred securities:						
Pooled	—	—	20	210	20	210
Individual issuer	—	—	847	153	847	153
<b>Total</b>	<b>\$ 184,367</b>	<b>4,781</b>	<b>4,074</b>	<b>841</b>	<b>188,441</b>	<b>5,622</b>
<b>December 31, 2009:</b>						
Agency obligations	\$ 46,219	630	—	—	46,219	630
Agency RMBS	48,343	380	—	—	48,343	380
State and political subdivisions	18,868	351	2,837	227	21,705	578
Trust preferred securities:						
Pooled	13	37	10	220	23	257
Individual issuer	—	—	1,440	2,010	1,440	2,010
Corporate debt	—	—	2,876	626	2,876	626
<b>Total</b>	<b>\$ 113,443</b>	<b>1,398</b>	<b>7,163</b>	<b>3,083</b>	<b>120,606</b>	<b>4,481</b>

The applicable dates for determining when securities are in an unrealized loss position are December 31, 2010 and 2009. As such, it is possible that a security had a market value that exceeded its amortized cost on other days during the past twelve-month period.

The Company recognized approximately \$0.8 million in other-than-temporary impairment in 2010 related to corporate debt securities that management intended to sell at December 31, 2010. These securities were disposed of in January of 2011 and are not included in the above table, as any related unrealized losses were recognized in earnings. For the securities in the above table, the Company does not have the intent to sell and has determined for securities evaluated at December 31, 2010, it is not more likely-than-not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. The Company has assessed each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities’ amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

In determining whether a loss is temporary, the Company considers all relevant information including:

- the length of time and the extent to which the fair value has been less than the amortized cost basis;
- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);

- the historical and implied volatility of the fair value of the security;
- the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency; and
- recoveries or additional declines in fair value subsequent to the balance sheet date.

To the extent the Company estimates future expected cash flows, the Company considered all available information in developing those expected cash flows. For asset-backed securities such as pooled trust preferred securities, such information generally included:

- remaining payment terms of the security (including as applicable, terms that require underlying obligor payments to increase in the future);
- current delinquencies and nonperforming assets of underlying collateral;
- expected future default rates; and
- Subordination levels or other credit enhancements.

### *Agency obligations*

The unrealized losses associated with agency obligations are primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities are issued by U.S. government agencies or government-sponsored entities and do not have any credit losses given the explicit or implicit government guarantee.

### *Agency residential mortgage-backed securities ("RMBS")*

The unrealized losses associated with Agency RMBS are primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities are issued by U.S. government agencies or government-sponsored entities and do not have any credit losses given the explicit or implicit government guarantee.

### *Securities of U.S. states and political subdivisions*

The unrealized losses associated with securities of U.S. states and political subdivisions are primarily driven by changes in interest rates and are not due to the credit quality of the securities. These securities will continue to be monitored as part of the Company's quarterly impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond insurers. As a result, the Company expects to recover the entire amortized cost basis of these securities.

### *Pooled trust preferred securities*

The unrealized losses associated with pooled trust preferred securities are primarily driven by higher projected collateral losses and wider credit spreads. Pooled trust preferred securities primarily consist of securities issued by community banks and thrifts. The Company assesses impairment for these securities using a cash flow model. The key assumptions include default probabilities of the underlying collateral and recoveries on collateral defaults. Based upon the Company's assessment of the expected credit losses for these securities, and given the performance of the underlying collateral compared to the Company's credit enhancement, the Company expects to recover the remaining amortized cost basis of these securities.

### *Individual issuer trust preferred securities*

The unrealized losses associated with individual issuer trust preferred securities are primarily related to securities backed by individual issuer community banks. For individual issuers, management evaluates the financial performance of the issuer on a quarterly basis to determine if it is probable that the issuer can make all contractual principal and interest payments. Based upon its evaluation, the Company expects to recover the remaining amortized cost basis of these securities.

### *Cost-method investments*

At December 31, 2010, cost-method investments with an aggregate cost of \$5.8 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

The carrying values of the Company's investment securities could decline in the future if the underlying performance of the collateral for pooled trust preferred securities, the financial condition of individual issuers of trust preferred securities, or the credit quality of other securities deteriorate and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that significant other-than-temporary impairment charges may occur in the future.

The following tables show the applicable credit ratings, fair values, gross unrealized losses, and life-to-date impairment charges for pooled and individual issuer trust preferred securities at December 31, 2010 and 2009, respectively, segregated by those securities that have been in an unrealized loss position for less than twelve months and twelve months or more.

#### Trust Preferred Securities as of December 31, 2010

(Dollars in thousands)	Credit Rating		Fair value	Unrealized losses			Life-to-date Impairment Charges
	Moody's	Fitch		Less than 12 months	12 months or longer	Total	
<b>Pooled:</b>							
ALESCO Preferred Funding XVII, Ltd. (a)	Ca	C	\$ 20	—	210	210	\$ 1,770
Total pooled			20	—	210	210	1,770
<b>Individual issuer (b):</b>							
Carolina Financial Capital Trust I	n/a	n/a	312	—	—	—	138
Main Street Bank Statutory Trust I (c)	n/a	n/a	438	—	62	62	—
MNB Capital Trust I	n/a	n/a	152	—	—	—	348
PrimeSouth Capital Trust I	n/a	n/a	197	—	—	—	303
TCB Trust	n/a	n/a	409	—	91	91	—
United Community Capital Trust	n/a	n/a	621	—	—	—	379
Total individual issuer			2,129	—	153	153	1,168
Total trust preferred securities			\$ 2,149	\$ —	363	363	\$ 2,938

n/a - not applicable, securities not rated.

- (a) Class B Deferrable Third Priority Secured Floating Rate Notes. The underlying collateral is primarily composed of trust preferred securities issued by community banks and thrifts.
- (b) 144A Floating Rate Capital Securities. Underlying issuer is a community bank holding company. Securities have no excess subordination or overcollateralization.
- (c) Now an obligation of BB&T Corporation.

**Trust Preferred Securities as of December 31, 2009**

	Credit Rating		Fair value	Unrealized losses			Life-to-date Impairment Charges
	Moody's	Fitch		Less than 12 months	12 months or longer	Total	
(Dollars in thousands)							
<b>Pooled:</b>							
ALESCO Preferred Funding XVII, Ltd. (a)	Ca	B	\$ 10	—	220	220	\$ 1,770
U.S. Capital Funding IV, Ltd. (b)	Ca	CC	13	37	—	37	2,450
Total pooled			23	37	220	257	4,220
<b>Individual issuer (c):</b>							
Carolina Financial Capital Trust I	n/a	n/a	90	—	360	360	—
Main Street Bank Statutory Trust I (d)	n/a	n/a	275	—	225	225	—
MNB Capital Trust I	n/a	n/a	125	—	375	375	—
PrimeSouth Capital Trust I	n/a	n/a	125	—	375	375	—
TCB Trust	n/a	n/a	325	—	175	175	—
United Community Capital Trust	n/a	n/a	500	—	500	500	—
Total individual issuer			1,440	—	2,010	2,010	—
Total trust preferred securities			\$ 1,463	\$ 37	2,230	2,267	\$ 4,220

n/a - not applicable, securities not rated.

- (a) Class B Deferrable Third Priority Secured Floating Rate Notes. The underlying collateral is primarily composed of trust preferred securities issued by community banks and thrifts.
- (b) Class B-2 Fixed/Floating Rate Senior Subordinate Notes. The underlying collateral is primarily composed of trust preferred securities issued by community banks and thrifts.
- (c) 144A Floating Rate Capital Securities. Underlying issuer is a community bank holding company. Securities have no excess subordination or overcollateralization.
- (d) Now an obligation of BB&T Corporation.

For pooled trust preferred securities, the Company estimated expected future cash flows of the security by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which consider default probabilities derived from issuer credit ratings for the underlying collateral). The probability-weighted expected future cash flows of the security are then discounted at the interest rate used to recognize income on the security to arrive at a present value amount.

Excess subordination is defined as the amount of performing collateral that is in excess of what is needed to pay-off a specified class of securities and all classes senior to the specified class. Performing collateral is defined as total collateral minus all collateral that is currently deferring or currently in default. This definition assumes that all collateral that is currently deferring will default with a zero recovery rate. The underlying issuers can cure the deferral, or some portion greater than zero could be recovered on default of an underlying issuer. Excess subordination, as defined previously, does not consider any excess interest spread that is built into the structure of the security, which provides another source of repayment for the bonds.

At December 31, 2010 and 2009, respectively, there was no excess subordination for the Class B notes of ALESCO Preferred Funding XVII, Ltd.

**Other-Than-Temporarily Impaired Securities**

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses), net.

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the Company will be required to sell the debt security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more-likely-than-not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings, as a realized loss in securities gains (losses), and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and the credit component of the loss is recognized in earnings (referred to as "credit-impaired" debt securities). Other-than-temporary impairments recognized in earnings for the years ended December 31, 2010 and 2009 for credit-impaired debt securities are presented as additions in two components based upon whether the current year is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). The credit loss component is reduced if the Company sells, intends to sell or believes it will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if the Company receives cash flows in excess of what it expected to receive over the remaining life of the credit-impaired debt security, the security matures or is fully written-down and deemed worthless. Changes in the credit loss component of credit-impaired debt securities were:

	Years ended December 31	
	2010	2009
<i>(Dollars in thousands)</i>		
Balance, beginning of period	\$ 4,570	\$ —
Additions:		
Initial credit impairments	1,160	2,663
Subsequent credit impairments	58	1,907
Reductions:		
Securities sold	(975)	—
Securities fully written-down and deemed worthless	(1,875)	—
Balance, end of period	\$ 2,938	\$ 4,570

### Other-Than-Temporary Impairment

The following table presents details of other-than-temporary impairment related to securities, including equity securities carried at cost, for the years ended December 31, 2010 and 2009.

	Years ended December 31	
	2010	2009
<i>(Dollars in thousands)</i>		
<b>Other-than-temporary impairment charges (included in earnings):</b>		
Debt securities:		
Corporate debt securities	\$ 810	\$ —
Pooled trust preferred securities	50	2,695
Individual issuer trust preferred securities	1,168	1,875
Total debt securities	2,028	4,570
Cost-method investments	—	1,980
Total other-than-temporary impairment charges	\$ 2,028	\$ 6,550
<b>Other-than-temporary impairment on debt securities:</b>		
Recorded as part of gross realized losses:		
Credit-related	\$ 1,218	4,570
Securities with intent to sell	810	—
Recorded directly to other comprehensive income for non-credit related impairment	210	257
Total other-than-temporary impairment on debt securities	\$ 2,238	\$ 4,827



**Realized Gains and Losses**

The following table presents the gross realized gains and losses on securities, including cost-method investments. Realized losses include other-than-temporary impairment charges.

(Dollars in thousands)	Years ended December 31		
	2010	2009	2008
Gross realized gains	\$ 3,496	\$ 2,881	\$ 406
Gross realized losses	(2,073)	(6,584)	(1,574)
Net realized gains (losses)	\$ 1,423	\$ (3,703)	\$ (1,168)

**NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES**
**Loan Portfolio**

(In thousands)	December 31	
	2010	2009
Commercial and industrial	\$ 53,288	\$ 53,884
Construction and land development	47,850	56,820
Commercial real estate:		
Owner occupied	76,252	78,695
Other	89,989	78,233
Total commercial real estate	166,241	156,928
Residential real estate:		
Consumer mortgage	57,562	62,259
Investment property	38,679	35,148
Total residential real estate	96,241	97,407
Consumer installment	10,676	11,236
Total loans	374,296	376,275
Less: unearned income	(81)	(172)
Loans, net of unearned income	\$ 374,215	\$ 376,103

Loans secured by real estate were approximately 82.9% of the total loan portfolio at December 31, 2010. Due to declines in economic indicators and real estate values, loans secured by real estate may have a greater risk of non-collection than other loans. At December 31, 2010, the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

In accordance with ASC 310, a portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. The Company's loan portfolio is disaggregated into the following portfolio segments: commercial and industrial, construction and land development, commercial real estate, residential real estate and consumer installment. The Company's loan portfolio segments were determined based on collateral type. Where appropriate, the Company's loan portfolio segments are further disaggregated into classes. A class is generally determined based on the initial measurement attribute, risk characteristics of the loan, and an entity's method for monitoring and determining credit risk.

The following describe the risk characteristics relevant to each of the portfolio segments.

*Commercial and Industrial ("C&I")*— includes loans to finance business operations, equipment purchases, or other needs for small and medium-sized commercial customers. Also included in this category are loans to finance agricultural production. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower.

*Construction and land development ("C&D")*— includes both loans and credit lines for the purpose of purchasing, carrying and developing land into commercial developments or residential subdivisions. Also included are loans and lines for construction of residential, multi-family and commercial buildings. Generally the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

*Commercial real estate* (“CRE”) – includes loans disaggregated into two classes: (1) owner occupied and (2) other.

- *Owner occupied* – includes loans secured by business facilities to finance business operations, equipment and owner-occupied facilities primarily for small and medium-sized commercial customers. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower, who owns the property.
- *Other* – primarily includes loans to finance income-producing commercial and multi-family properties. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, warehouses and apartments leased generally to local businesses and residents. Generally the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates as well as the financial health of the borrower.

*Residential real estate* (“RRE”) – includes loans disaggregated into two classes: (1) consumer mortgage and (2) investment property.

- *Consumer mortgage* – primarily include first lien, or second lien mortgages and home equity lines to consumers that are secured by a primary residence or second home. These loans are underwritten in accordance with the Bank’s general loan policies and procedures which require, among other things, proper documentation of each borrower’s financial condition, satisfactory credit history and property value.
- *Investment property* – primarily includes loans to finance income-producing 1-4 family residential properties. Generally the primary source of repayment is dependent upon income generated from leasing the property securing the loan. The underwriting of these loans takes into consideration the rental rates as well as the financial health of the borrower.

*Consumer installment* – includes loans to individuals both secured by personal property and unsecured. Loans include personal lines of credit, automobile loans, and other retail loans. These loans are underwritten in accordance with the Bank’s general loan policies and procedures which require, among other things, proper documentation of each borrower’s financial condition, satisfactory credit history, and if applicable, property value.

The following is a summary of current, accruing past due and nonaccrual loans by portfolio class as of December 31, 2010.

(In thousands)	December 31, 2010					
	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non- Accrual	Total Loans
Commercial and industrial	\$ 52,643	124	—	52,767	521	\$ 53,288
Construction and land development	43,547	201	—	43,748	4,102	47,850
Commercial real estate:						
Owner occupied	73,419	—	—	73,419	2,833	76,252
Other	88,087	—	—	88,087	1,902	89,989
Total commercial real estate	161,506	—	—	161,506	4,735	166,241
Residential real estate:						
Consumer mortgage	53,225	2,219	—	55,444	2,118	57,562
Investment property	37,556	767	—	38,323	356	38,679
Total residential real estate	90,781	2,986	—	93,767	2,474	96,241
Consumer installment	10,646	29	—	10,675	1	10,676
Total	\$ 359,123	3,340	—	362,463	11,833	\$ 374,296

At December 31, 2010 and 2009, nonaccrual loans amounted to \$11.8 million and \$9.4 million, respectively. The gross interest income which would have been recorded under the original terms of those loans had they been accruing interest, amounted to approximately \$346 thousand, \$161 thousand, and \$199 thousand for the years ended December 31, 2010, 2009, and 2008, respectively. At December 31, 2010 there were no loans 90 days past due and still accruing interest. At December 31, 2009, loans 90 days past due and still accruing interest amounted to \$5 thousand.

**Allowance for Loan Losses**

The allowance for loan losses as of and for the years ended December 31, 2010, 2009 and 2008, is presented below.

<i>(Dollars in thousands)</i>	Years ended December 31		
	2010	2009	2008
Balance at beginning of period	\$ 6,495	4,398	4,105
Charge-offs	(2,687)	(3,348)	(705)
Recoveries	288	195	128
Net charge-offs	(2,399)	(3,153)	(577)
Provision for loan losses	3,580	5,250	870
Ending balance	\$ 7,676	6,495	4,398

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolios, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loan losses are charged off when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a "confirming event" has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely. Allocation of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, is deemed to be uncollectible.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan (recorded investment in the loan is the principal balance plus any accrued interest, net of deferred loan fees or costs and unamortized premium or discount). The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan's effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs. The Company believes it follows appropriate accounting and regulatory guidance in determining impairment and accrual status of impaired loans.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing independent loan review process. The Company's loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company's loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that we will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial loans, construction and land development loans, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it

does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2010, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups. The related adjustments increased the allowance for loan losses for this portfolio segment at December 31, 2010.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management's estimate of probable losses for several "qualitative and environmental" factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company maintains an unallocated amount for inherent factors that cannot be practically assigned to individual loan segments or categories. An example is the imprecision in the overall measurement process.

The Company constantly re-evaluates its practices in determining the allowance for loan losses. For example, in order to better capture the effect of current economic conditions on the Company's loan loss experience, the Company calculated average losses by loan segment using a rolling 6 quarter historical period starting from the quarter ended September 30, 2010. Prior to September 30, 2010, the Company calculated average losses using a rolling 12 quarter historical period.

The following table details the allowance for loan losses at December 31, 2010 by portfolio segment:

	December 31, 2010						
(In thousands)	(1) C&I	(2) C&D	(3) CRE	(4) RRE	Consumer Installment	Unallocated	Total
<b>Allowance for loan losses</b>	\$ 972	2,223	2,893	1,336	141	111	\$ 7,676
Individually evaluated	277	123	765	144	—	—	1,309
Collectively evaluated	695	2,100	2,128	1,192	141	111	6,367
<b>Total loans</b>	\$ 53,288	47,850	166,241	96,241	10,676		\$ 374,296
Individually evaluated	521	4,102	4,630	2,418	—		11,671
Collectively evaluated	52,767	43,748	161,611	93,823	10,676		362,625

- (1) Commercial and industrial.
- (2) Construction and land development.
- (3) Commercial real estate.
- (4) Residential real estate.

**Credit Quality Indicators**

The credit quality of the loan portfolio is summarized no less frequently than quarterly using categories similar to the standard asset classification system used by the federal banking agencies. The following table presents credit quality indicators for the loan portfolio segments and classes. These categories are utilized to develop the associated allowance for loan losses using historical losses adjusted for current economic conditions and are defined as follows:

- Pass – loans which are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral.
- Special Mention – loans with potential weakness that may, if not reversed or corrected, weaken the credit or inadequately protect the Company's position at some future date. These loans are not adversely classified and do not expose an institution to sufficient risk to warrant an adverse classification.
- Accruing Substandard – loans that exhibit a well-defined weakness which presently jeopardizes debt repayment, even though they are currently performing. These loans are characterized by the distinct possibility that the Company may incur a loss in the future if these weaknesses are not corrected;
- Nonaccrual – includes loans where management has determined that full payment of principal and interest is in doubt.

<b>December 31, 2010</b>					
<i>(In thousands)</i>	<b>Pass</b>	<b>Special Mention</b>	<b>Accruing Substandard</b>	<b>Nonaccrual</b>	<b>Total Loans</b>
Commercial and industrial	\$ 51,632	722	413	521	\$ 53,288
Construction and land development	38,301	4,372	1,075	4,102	47,850
Commercial real estate:					
Owner occupied	67,702	716	5,001	2,833	76,252
Other	84,354	3,718	15	1,902	89,989
Total commercial real estate	152,056	4,434	5,016	4,735	166,241
Residential real estate:					
Consumer mortgage	48,620	2,700	4,124	2,118	57,562
Investment property	34,221	1,626	2,476	356	38,679
Total residential real estate	82,841	4,326	6,600	2,474	96,241
Consumer installment	10,426	133	116	1	10,676
Total	\$ 335,256	13,987	13,220	11,833	\$ 374,296

**Impaired loans**

The following table presents details related to the Company's impaired loans. Loans which have been fully charged-off do not appear in the following table. The related allowance generally represents the following components which correspond to impaired loans:

- Individually evaluated impaired loans equal to or greater than \$500,000 secured by real estate (nonaccrual construction and land development, commercial real estate, and residential real estate loans).
- Individually evaluated impaired loans equal to or greater than \$250,000 not secured by real estate (nonaccrual commercial and industrial and consumer loans).

The following table sets forth certain information regarding the Company's impaired loans that were individually evaluated for impairment at December 31, 2010.

	December 31, 2010			
(In thousands)	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
<b>With no allowance recorded:</b>				
Commercial and industrial	\$ —	\$ —	\$ —	
Construction and land development	2,538	(54)	2,484	
Commercial real estate:				
Owner occupied	—	—	—	
Other	1,592	(51)	1,541	
Total commercial real estate	1,592	(51)	1,541	
Residential real estate:				
Consumer mortgage	1,072	(27)	1,045	
Investment property	356	—	356	
Total residential real estate	1,428	(27)	1,401	
Consumer installment	—	—	—	
Total	\$ 5,558	\$ (132)	\$ 5,426	
<b>With allowance recorded:</b>				
Commercial and industrial	\$ 528	\$ (7)	\$ 521	\$ 277
Construction and land development	1,618	—	1,618	123
Commercial real estate:				
Owner occupied	3,124	(35)	3,089	765
Other	—	—	—	—
Total commercial real estate	3,124	(35)	3,089	765
Residential real estate:				
Consumer mortgage	1,073	(56)	1,017	144
Investment property	—	—	—	—
Total residential real estate	1,073	(56)	1,017	144
Consumer installment	—	—	—	—
Total	\$ 6,343	\$ (98)	\$ 6,245	\$ 1,309
<b>Total impaired loans</b>	<b>\$ 11,901</b>	<b>\$ (230)</b>	<b>\$ 11,671</b>	<b>\$ 1,309</b>

- (1) Unpaid principal balance represents the contractual obligation due from the customer.
- (2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.
- (3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

For the years ended December 31, 2010, 2009 and 2008, the average recorded investments in impaired loans were \$9.2 million, \$4.0 million and \$2.6 million, respectively. Total interest income recognized on impaired loans for the years ended December 31, 2010, 2009, and 2008 was not material.

At December 31, 2010 and 2009, the Company had impaired loans classified as TDRs of \$7.6 million and \$1.2 million, respectively. At December 31, 2010 and 2009, the Company had no accruing TDRs. For impaired loans classified as TDRs, the related allowance for loan losses was approximately \$1.0 million at December 31, 2010. At December 31, 2010, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.



**NOTE 6: PREMISES AND EQUIPMENT**

Premises and equipment at December 31, 2010 and 2009 is presented below.

<i>(Dollars in thousands)</i>	<b>December 31</b>	
	<b>2010</b>	<b>2009</b>
Land	\$ 4,678	\$ 4,678
Buildings and improvements	6,708	6,673
Furniture, fixtures, and equipment	3,290	3,565
Total premises and equipment	14,676	14,916
Less: accumulated depreciation	(6,571)	(6,634)
Premises and equipment, net	\$ 8,105	\$ 8,282

Depreciation expense was approximately \$319 thousand, \$320 thousand, and \$312 thousand for the periods ended December 31, 2010, 2009 and 2008, respectively.

**NOTE 7: MORTGAGE SERVICING RIGHTS, NET**

MSRs are recognized based on the fair value of the servicing right on the date the corresponding mortgage loan is sold. An estimate of the Company's MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income.

The Company has recorded MSRs related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. Prior to January 1, 2009, the volume of loans sold servicing retained was not significant; therefore no servicing rights were capitalized.

The change in amortized MSRs and the related valuation allowance for the years ended December 31, 2010 and 2009, is presented below.

<i>(Dollars in thousands)</i>	<b>Years ended December 31</b>	
	<b>2010</b>	<b>2009</b>
Beginning Balance	\$ 834	—
Additions, net	524	914
Amortization expense	(169)	(80)
Change in valuation allowance	—	—
Ending Balance	\$ 1,189	834

**Fair value of amortized MSRs:**

Beginning of year	978	—
End of year	\$ 1,335	978

At December 31, 2010 and 2009, there was no valuation allowance for amortized MSRs. The Company periodically evaluates mortgage servicing rights for impairment. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation reserve is established. The valuation reserve is adjusted as the fair value changes.

Data and assumptions used in the fair value calculation related to MSR's at December 31, 2010 are presented below.

<i>(Dollars in thousands)</i>	Years ended December 31	
	2010	2009
Unpaid principal balance	\$ 157,929	106,313
Weighted average prepayment speed (CPR)	12.1%	10.0
Discount rate (annual percentage)	11.0%	11.0
Weighted average coupon interest rate	4.6%	4.8
Weighted average remaining maturity (months)	289	311
Weighted average servicing fee (basis points)	25.0	25.0

At December 31, 2010, the weighted average amortization period for MSR's was 6.2 years. Estimated amortization expense for each of the next five years is presented below.

<i>(Dollars in thousands)</i>	December 31, 2010
2011	\$ 184
2012	160
2013	136
2014	115
2015	97

#### NOTE 8: DEPOSITS

At December 31, 2010, the scheduled maturities of certificates of deposit and other time deposits are presented below.

<i>(Dollars in thousands)</i>	December 31, 2010
2011	\$ 150,989
2012	59,297
2013	34,257
2014	20,888
2015	16,073
Thereafter	24,609
Total certificates of deposit and other time deposits	\$ 306,113

Additionally, at December 31, 2010 and 2009, approximately \$190.3 and \$200.5 million, respectively, of certificates of deposit and other time deposits were issued in denominations of \$100,000 or greater.

At December 31, 2010 and 2009, the amount of deposit accounts in overdraft status that were reclassified to loans on the accompanying consolidated balance sheets was not material.

**NOTE 9: SHORT-TERM BORROWINGS**

	2010		2009		2008	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
<i>(Dollars in thousands)</i>						
<b>Federal funds purchased:</b>						
As of December 31	\$ —	—	\$ 12,450	0.93 %	\$ —	—
Average during the year	1,125	0.94 %	498	0.88 %	6,837	2.55 %
Maximum outstanding at any month-end	—		12,450		18,204	
<b>Securities sold under agreements to repurchase:</b>						
As of December 31	\$ 2,685	0.50 %	\$ 3,510	0.50 %	\$ 10,910	0.04 %
Average during the year	2,404	0.50 %	10,292	0.50 %	9,767	1.53 %
Maximum outstanding at any month-end	2,858		15,224		13,095	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling \$34.0 million with none outstanding at December 31, 2010.

Securities sold under agreements to repurchase represent short-term borrowings with maturities less than one year collateralized by a portion of the Company's securities portfolio. Securities with an aggregate carrying value of \$5.0 million and \$9.7 million at December 31, 2010 and 2009, respectively, were pledged to secure securities sold under agreements to repurchase.

**NOTE 10: LONG-TERM DEBT**

At December 31, 2010 and 2009, the composition of long-term debt is presented below.

	2010		2009	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
<i>(Dollars in thousands)</i>				
FHLB advances, due 2011 to 2018	\$ 71,114	3.88 %	\$ 86,132	4.01 %
Securities sold under agreements to repurchase, due 2017	15,000	4.21	25,000	4.08
Subordinated debentures, due 2033	7,217	3.38	7,217	3.38
<b>Total long-term debt</b>	<b>\$ 93,331</b>	<b>3.90 %</b>	<b>\$ 118,349</b>	<b>3.99 %</b>

The Bank had \$71.1 million and \$86.1 million of FHLB advances with original maturities greater than one year at December 31, 2010 and 2009, respectively. Securities with an aggregate carrying value of \$52.8 million and \$62.6 million and certain qualifying residential mortgage loans with an aggregate carrying value of \$48.9 million and \$49.3 million at December 31, 2010 and 2009, respectively, were pledged to secure long-term FHLB advances.

The Bank had \$15.0 million and \$25.0 million in securities sold under agreements to repurchase with an original maturity greater than one year at December 31, 2010 and 2009, respectively. Securities with an aggregate carrying value of \$19.0 million and \$28.5 million at December 31, 2010 and 2009, respectively, were pledged to secure long-term securities sold under agreements to repurchase.

The Company formed Auburn National Bancorporation Capital Trust I ("Trust"), a wholly-owned statutory business trust, in 2003. The Trust issued \$7.0 million of trust preferred securities that were sold to third parties. The proceeds from the sale of the trust preferred securities and trust common securities that we hold, were used to purchase subordinated debentures of \$7.2 million from the Company, which are presented as long-term debt in the consolidated balance sheets and qualify for inclusion in Tier 1 capital for regulatory capital purposes, subject to certain limitations. The debentures mature on December 31, 2033 and may be redeemed on or after December 31, 2008.

The following is a schedule of annual maturities of long-term debt:

<i>(Dollars in thousands)</i>	2011	2012	2013	2014	2015	Thereafter	Total
FHLB advances	\$ 8,018	18	15,018	20,018	18,018	10,024	71,114
Securities sold under agreements to repurchase	—	—	—	—	—	15,000	15,000
Subordinated debentures	—	—	—	—	—	7,217	7,217
Total long-term debt	\$ 8,018	18	15,018	20,018	18,018	32,241	93,331

#### NOTE 11: OTHER COMPREHENSIVE INCOME (LOSS)

Comprehensive income is defined as the change in equity from all transactions other than those with shareholders, and it includes net earnings and other comprehensive income (loss). Other comprehensive income (loss) for the years ended December 31, 2010, 2009, and 2008, is presented below.

<i>(In thousands)</i>	Pre-tax amount	Tax benefit (expense)	Net of tax amount
<b>2010:</b>			
Unrealized net holding loss on other-than-temporarily impaired securities due to factors other than credit	\$ (210)	77	(133)
Unrealized net holding loss on all other securities	(2,032)	751	(1,281)
Reclassification adjustment for net gain on securities recognized in net earnings	(1,423)	525	(898)
Other comprehensive loss	\$ (3,665)	1,353	(2,312)
<b>2009:</b>			
Unrealized net holding loss on other-than-temporarily impaired securities due to factors other than credit	\$ (257)	95	(162)
Unrealized net holding loss on all other securities	(4,226)	1,559	(2,667)
Reclassification adjustment for net loss on securities recognized in net earnings	3,703	(1,366)	2,337
Other comprehensive loss	\$ (780)	288	(492)
<b>2008:</b>			
Unrealized net holding gain on securities	\$ 450	(187)	263
Reclassification adjustment for net loss on securities recognized in net earnings	1,168	(431)	737
Other comprehensive income	\$ 1,618	(618)	1,000

#### NOTE 12: INCOME TAXES

For the years ended December 31, 2010, 2009, and 2008 the components of income tax expense (benefit) from continuing operations are presented below.

<i>(Dollars in thousands)</i>	Years ended December 31		
	2010	2009	2008
Current income taxes:			
Federal	\$ 1,290	\$ 1,563	2,321
State	285	287	370
Total current income taxes	1,575	1,850	2,691
Deferred income taxes:			
Federal	(698)	(1,930)	(589)
State	(79)	(260)	(79)
Total deferred income taxes	(777)	(2,190)	(668)
Total income tax expense (benefit)	\$ 798	\$ (340)	2,023

Total income tax expense differs from the amounts computed by applying the statutory federal income tax rate of 34% to earnings before income taxes. A reconciliation of the differences for the years ended December 31, 2010, 2009 and 2008, is presented below. As discussed in Footnote 1, income tax expense for the year ended December 31, 2009 included a \$281 thousand tax benefit related to the correction of an error in prior periods. The error resulted from the incorrect calculation of tax basis for certain available-for-sale securities, primarily related to periods prior to January 1, 2007.

	2010		2009		2008	
	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings
<i>(Dollars in thousands)</i>						
Earnings before income taxes	\$ 6,144		\$ 2,064		\$ 8,660	
Income taxes at statutory rate	2,089	34.0 %	702	34.0 %	2,944	34.0 %
Tax-exempt interest	(1,042)	(17.0)	(939)	(45.5)	(779)	(9.0)
State income taxes, net of federal tax effect	151	2.5	44	2.1	192	2.2
Low-income housing credit	(220)	(3.6)	(228)	(11.0)	(228)	(2.6)
Bank owned life insurance	(154)	(2.5)	(144)	(7.0)	(160)	(1.8)
Change in valuation allowance	—	—	505	24.5	—	—
Correction of prior period error	—	—	(281)	(13.6)	—	—
Other	(26)	(0.4)	1	0.0	54	0.6
Total income tax expense (benefit)	\$ 798	13.0 %	(340)	(16.5) %	2,023	23.4 %

The Company had net deferred tax assets of \$5.8 million and \$3.7 million at December 31, 2010 and 2009, respectively. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2010 and 2009 are presented below:

	December 31	
	2010	2009
<i>(Dollars in thousands)</i>		
Deferred tax assets:		
Allowance for loan losses	\$ 2,832	2,397
Securities	1,549	1,723
Unrealized loss on securities	1,288	—
Other real estate owned	466	—
Other assets	274	186
Capital loss carryforwards	505	731
Tax credit carryforwards	108	—
Other	127	38
Total deferred tax assets	7,149	5,075
Less: valuation allowance for nondeductible capital losses	(505)	(505)
Total deferred tax assets less valuation allowance	6,644	4,570
Deferred tax liabilities:		
Depreciation	59	189
Discount accretion	150	165
Unrealized gain on securities	—	65
FHLB stock dividends	23	24
Prepaid expenses	99	79
Deferred loan fees	61	57
Originated mortgage servicing rights	439	308
Total deferred tax liabilities	831	887
Net deferred tax asset	\$ 5,813	3,683

At December 31, 2010, the Company had U.S. federal tax credit carryforwards of approximately \$0.1 million, which expire in 2020. Additionally, at December 31, 2010, the Company had capital loss carryforwards of approximately \$0.5 million that expire in 2014. The Company's capital loss carryforwards at December 31, 2010 and 2009, respectively,

were primarily attributable to a capital loss for income tax purposes related to its investments in the common stock of Silverton Financial Services, Inc, the holding company of Silverton Bank, which failed on May 1, 2009.

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion of the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment.

The Company had a valuation allowance for deferred tax assets of approximately \$0.5 million at December 31, 2010 and 2009, respectively, which reduced its deferred tax asset related to capital loss carryforwards to an amount that management believes will more-likely-than-not be realized. Based upon the level of historical taxable income and projection for future taxable income over the periods which the temporary differences resulting in the remaining deferred tax assets are deductible, management believes it is more-likely-than-not that the Company will realize the benefits of its remaining deferred tax assets at December 31, 2010. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

The change in the net deferred tax asset for the years ended December 31, 2010, 2009 and 2008, is presented below.

(Dollars in thousands)	Years ended December 31		
	2010	2009	2008
<b>Net deferred tax asset:</b>			
Balance, beginning of year	\$ 3,683	1,205	1,155
Deferred tax benefit related to continuing operations	777	2,190	668
Stockholders' equity, for accumulated other comprehensive loss (income)	1,353	288	(618)
Balance, end of year	\$ 5,813	3,683	1,205

ASC 740 defines the threshold for recognizing the benefits of tax return positions in the financial statements as “more-likely-than-not” to be sustained by the taxing authority. This section also provides guidance on the derecognition, measurement and classification of income tax uncertainties in interim periods. As of December 31, 2010, the Company had no unrecognized tax benefits related to federal or state income tax matters. The Company does not anticipate any material increase or decrease in unrecognized tax benefits during 2011 relative to any tax positions taken prior to December 31, 2010. As of December 31, 2010, the Company has accrued no interest and no penalties related to uncertain tax positions. It is the Company’s policy to recognize interest and penalties related to income tax matters in income tax expense.

The Company and its subsidiaries file consolidated U.S. federal and State of Alabama income tax returns. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2007 through 2010. The Company is also currently open to audit by the State of Alabama for the years ended December 31, 2007, through 2010, although certain matters have been closed.

#### NOTE 13: EMPLOYEE BENEFIT PLAN

The Company has a 401(k) Plan that covers substantially all employees. Participants may contribute up to 10% of eligible compensation subject to certain limits based on federal tax laws. The Company’s matching contributions to the Plan are determined by the board of directors. Participants become 20% vested in their accounts after two years of service and 100% vested after six years of service. Company matching contributions to the Plan were \$113 thousand, \$120 thousand, and \$119 thousand for the years ended December 31, 2010, 2009, and 2008, respectively, and are included in salaries and benefits expense.

#### NOTE 14: DERIVATIVE INSTRUMENTS

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings. From time to time, the Company may enter into interest rate swaps (“swaps”) to facilitate customer transactions and meet their financing



needs. Upon entering into these instruments to meet customer needs, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2010 the Company had no derivative contracts to assist in managing the Company's interest rate sensitivity.

Interest rate swap contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counter party or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument contract is negative, the Company owes the customer or counterparty and therefore, has no credit risk.

A summary of the Company's interest rate swaps as of and for the year ended December 31, 2010 is presented below.

		Other Assets	Other Liabilities	Other noninterest income
		Estimated Fair Value	Estimated Fair Value	Gains (Losses)
(Dollars in thousands)				
	Notional			
Interest rate swap agreements:				
Pay fixed / receive variable	\$ 6,067	\$ —	1,101	(170)
Pay variable / receive fixed	6,067	1,101	—	170
Total interest rate swap agreements	\$ 12,134	\$ 1,101	\$ 1,101	\$ —

## NOTE 15: COMMITMENTS AND CONTINGENT LIABILITIES

### *Credit-Related Financial Instruments*

The Company is party to credit related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

At December 31, 2010 and 2009, the following financial instruments were outstanding whose contract amount represents credit risk:

	December 31	
	2010	2009
<i>(Dollars in thousands)</i>		
Commitments to extend credit	\$ 41,747	\$ 46,505
Standby letters of credit	7,785	8,116
Commitments to fund affordable housing investments	4,378	—

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. The commitments for lines of credit may expire without being drawn upon. Therefore, total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds various assets as collateral supporting those commitments for which collateral is deemed necessary. The Company has recorded a liability for the estimated fair value of these standby letters of credit in the amount of \$54 thousand and \$90 thousand at December 31, 2010 and 2009, respectively.

Periodically, the Company may invest in various limited partnerships that sponsor affordable housing projects in its primary markets and surrounding areas as a means of supporting local communities. When commitments to fund affordable housing investments are contingent upon a future event, a liability must be recognized when that contingent event becomes probable. At December 31, 2010, total unfunded commitments outstanding for affordable housing investments were \$4.4 million, of which \$1.9 million was included in other liabilities. At December 31, 2009, the Company had no unfunded commitments related to affordable housing investments. For further discussion of the Company's involvement with affordable housing investments, see Note 2, Variable Interest Entities.

#### ***Other Commitments***

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2010, are as follows: 2011, \$332 thousand; 2012, \$229 thousand; 2013, \$134 thousand; 2014, \$51 thousand; 2015, \$37 thousand.

#### ***Contingent Liabilities***

The Company and the Bank are involved in various legal proceedings, arising in connection with their business. In the opinion of management, based upon consultation with legal counsel, the ultimate resolution of these proceeding will not have a material adverse affect upon the consolidated financial condition or results of operations of the Company and the Bank.

### **NOTE 16: FAIR VALUE DISCLOSURES**

"Fair value" is defined by FASB ASC 820, *Fair Value Measurements and Disclosures*, 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. FASB ASC 820 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the inputs market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1—inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2—inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3—inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The Company's assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy in accordance with FASB ASC 820.

*Securities* – Securities available-for-sale are recorded at fair value on a recurring basis. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government securities such as U.S. Treasuries and exchange-traded equity securities.

When instruments are traded in secondary markets and quoted market prices are not available, the Company generally relies on prices obtained from independent vendors. Vendors compile prices from various sources and often apply matrix pricing for similar securities when no price is observable. Securities measured with these valuation techniques are generally classified within Level 2 of the valuation hierarchy and often involve using quoted market prices for similar securities, pricing models or discounted cash flow analyses using inputs observable in the market where available. Examples include U.S. government agency securities and residential mortgage-backed securities.

Security fair value measurements using significant inputs that are unobservable in the market due to limited activity or a less liquid market are classified within Level 3 of the valuation hierarchy. Such measurements include securities valued using discounted cash flow models or a combination of valuation techniques such as weighting of models

and vendor or broker pricing, where the unobservable inputs are significant to the overall fair value measurement. Securities classified as Level 3 include pooled and individual issuer trust preferred securities.

*Loans held for sale* – Loans held for sale are carried at the lower of cost or estimated fair value and are subjected to nonrecurring fair value adjustments. Estimated fair value is determined on the basis of the current market value of similar loans. All of the Company's loans held for sale are classified within Level 2 of the valuation hierarchy.

*Loans, net* – Loans considered impaired under FASB ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are subject to nonrecurring fair value adjustments to reflect (1) partial write-downs that are based on the observable market price or current appraised value of the collateral, or (2) the full charge-off of the loan carrying value. All of the Company's impaired loans are classified within Level 3 of the valuation hierarchy.

*Other real estate* – Other real estate, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at the lower of the loan's carrying amount or the fair value less costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less costs to sell. Fair value is generally determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs. All of the Company's other real estate is classified within Level 3 of the valuation hierarchy.

*Other assets* – The Company has certain financial assets carried at fair value on a recurring basis, including interest rate swap agreements. The carrying amount of interest rate swap agreements is based on information obtained from a third party bank. The Company classified these derivative assets within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments. The Company had no derivative contracts to assist in managing interest rate sensitivity at December 31, 2010 or December 31, 2009.

Mortgage servicing rights, net, included in other assets on the accompanying consolidated balance sheets, are carried at the lower of cost or estimated fair value and are subjected to nonrecurring fair value adjustments. MSR's do not trade in an active market with readily observable prices. To determine the fair value of MSR's, the Company engages an independent third party. The independent third party's valuation model calculates the present value of estimated future net servicing income using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Because the valuation of MSR's requires the use of significant unobservable inputs, all of the Company's MSR's are classified within Level 3 of the valuation hierarchy.

*Other liabilities* – The Company has certain financial liabilities carried at fair value on a recurring basis, including interest rate swap agreements. The carrying amount of interest rate swap agreements is based on information obtained from a third party bank. The Company classified these derivative liabilities within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments. The Company had no derivative contracts to assist in managing interest rate sensitivity at December 31, 2010 or December 31, 2009.

## Assets and liabilities measured at fair value on a recurring basis

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 and 2009, respectively, by caption, on the consolidated balance sheets by FASB ASC 820 valuation hierarchy (as described above).

<i>(Dollars in thousands)</i>	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>December 31, 2010:</b>				
Securities available-for-sale:				
Agency obligations	\$ 90,471	—	90,471	—
Agency RMBS	143,144	—	143,144	—
States and political subdivisions	76,766	—	76,766	—
Trust preferred securities:				
Pooled	20	—	—	20
Individual issuer	2,129	—	—	2,129
Corporate debt	2,690	2,690	—	—
Total securities available-for-sale	315,220	2,690	310,381	2,149
Other assets <sup>(1)</sup>	1,101	—	1,101	—
<b>Total assets at fair value</b>	<b>\$ 316,321</b>	<b>2,690</b>	<b>311,482</b>	<b>2,149</b>
Other liabilities <sup>(1)</sup>	\$ 1,101	—	1,101	—
<b>Total liabilities at fair value</b>	<b>\$ 1,101</b>	<b>—</b>	<b>1,101</b>	<b>—</b>
<b>December 31, 2009:</b>				
Securities available-for-sale:				
Agency obligations	\$ 90,220	—	90,220	—
Agency RMBS	158,642	—	158,642	—
States and political subdivisions	81,562	—	81,562	—
Trust preferred securities:				
Pooled	23	—	—	23
Individual issuer	1,440	—	—	1,440
Corporate debt	2,875	—	2,875	—
Total securities available-for-sale	334,762	—	333,299	1,463
Other assets <sup>(1)</sup>	931	—	931	—
<b>Total assets at fair value</b>	<b>\$ 335,693</b>	<b>—</b>	<b>334,230</b>	<b>1,463</b>
Other liabilities <sup>(1)</sup>	\$ 931	—	931	—
<b>Total liabilities at fair value</b>	<b>\$ 931</b>	<b>—</b>	<b>931</b>	<b>—</b>

<sup>(1)</sup> Represents the fair value of interest rate swap agreements.

### Level changes in fair value measurements

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Corporation's monthly and/or quarterly valuation process. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company's financial assets and liabilities generally is such that transfers in and out of any level are expected to be rare. The Company disposed of its corporate debt securities during the first two weeks of January 2011. Due to the proximity between December 31, 2010 and the respective trade dates for these corporate debt securities sold, the Company determined that the trade price for each security approximated its fair value at December 31, 2010. Accordingly, the Company determined that its corporate securities should be transferred from

Level 2 and classified as Level 1 at December 31, 2010. For the year ended December 31, 2010, there were no other transfers between levels.

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements for financial assets recognized in the accompanying condensed consolidated balance sheets using Level 3 inputs:

(Dollars in thousands)	Years ended December 31	
	2010	2009
Beginning balance	\$ 1,463	\$ 8,705
Total realized and unrealized gains and (losses):		
Included in net earnings	(1,218)	(5,234)
Included in other comprehensive income	1,904	605
Purchases, issuances and settlements	—	—
Transfers in and/or (out) of Level 3	—	(2,613)
Ending balance	\$ 2,149	\$ 1,463

The transfer from Level 3 to Level 2 during the year ended December 31, 2009 primarily related to corporate debt securities. Due to an increase in trading activity and observable inputs for the Company's corporate debt securities during the year ended December 31, 2009, the fair value measurements for these securities were recognized using Level 2 inputs.

#### Assets and liabilities measured at fair value on a nonrecurring basis

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2010 and 2009, respectively, by caption, on the consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above):

(Dollars in thousands)	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>December 31, 2010:</b>				
Loans held for sale	\$ 4,281	—	4,281	—
Loans, net <sup>(1)</sup>	10,362	—	—	10,362
Other real estate owned	8,125	—	—	8,125
Other assets <sup>(2)</sup>	1,189	—	—	1,189
<b>Total assets at fair value</b>	<b>\$ 23,957</b>	<b>—</b>	<b>4,281</b>	<b>19,676</b>
<b>December 31, 2009:</b>				
Loans held for sale	\$ 4,881	—	4,881	—
Loans, net <sup>(1)</sup>	8,430	—	—	8,430
Other real estate owned	7,292	—	—	7,292
Other assets <sup>(2)</sup>	834	—	—	834
<b>Total assets at fair value</b>	<b>\$ 21,437</b>	<b>—</b>	<b>4,881</b>	<b>16,556</b>

<sup>(1)</sup> Loans considered impaired under FASB ASC 310-10-35, *Receivables*.

<sup>(2)</sup> Mortgage servicing rights, net included in this category.

#### NOTE 17: FAIR VALUE OF FINANCIAL INSTRUMENTS

FASB ASC 825, *Financial Instruments* requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow and other valuation techniques. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent

markets and should not be considered representative of the liquidation value of the Company's financial instruments, but rather a good-faith estimate of the fair value of financial instruments held by the Company. FASB ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

The following methods and assumptions were used by the Company in estimating the fair value of its financial instruments:

#### ***Cash and cash equivalents***

Due to their short-term nature, the carrying amounts reported in the balance sheet are assumed to approximate fair value for these assets. For purposes of disclosure, cash equivalents include federal funds sold and other short-term investments.

#### ***Securities***

Fair value measurement is based upon quoted prices if available. If quoted market prices are not available, estimated fair values are based on quoted market prices of comparable instruments. See Note 3 for additional disclosure related to fair value measurements for securities.

#### ***Loans held for sale***

Loans held for sale are carried at the lower of cost or estimated fair value and are subjected to nonrecurring fair value adjustments. Estimated fair value is determined on the basis of the current market value of similar loans.

#### ***Loans, net***

The fair value of loans is calculated using discounted cash flows. The discount rates used to determine the present value of the loan portfolio are estimated market discount rates that reflect the credit and interest rate risk inherent in the loan portfolio. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by FASB ASC 820 and generally produces a higher value than an exit-price approach. The estimated maturities are based on the Company's historical experience with repayments adjusted to estimate the effect of current market conditions. The carrying amount of accrued interest approximates its fair value.

#### ***Deposits***

Under FASB ASC 825, the fair value of deposits with no stated maturity, such as noninterest bearing demand deposits, interest bearing demand deposits and savings and certain types of money market accounts, is equal to the amount payable on demand at the reporting date (i.e., their carrying amount). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using discounted cash flows. The discount rates used are based on estimated market rates for deposits of similar remaining maturities.

#### ***Short-term borrowings***

The fair values of federal funds purchased, securities sold under agreements to repurchase, and other short-term borrowings approximate their carrying value.

#### ***Long-term debt***

The fair value of the Company's fixed rate long-term debt is estimated using discounted cash flows based on estimated current market rates for similar types of borrowing arrangements. The carrying amount of the Company's variable rate long-term debt approximates its fair value.

#### ***Derivative Instruments***

The Company enters into interest rate swaps to meet the financing, interest rate and equity risk management needs of its customers. The carrying amounts of these derivative instruments represent their fair value. Generally, the fair value of these instruments is based on an observable market price.

#### ***Off-balance sheet Instruments***

The fair values of the Company's off-balance-sheet financial instruments are based on fees charged to enter into similar agreements. However, commitments to extend credit do not represent a significant value to the Company until such commitments are funded. The Company has determined that the estimated fair value of commitments to extend credit approximates the carrying amount and is immaterial to the financial statements.



The carrying value and related estimated fair value of the Company's financial instruments at December 31, 2010 and December 31, 2009 are presented below.

	December 31, 2010		December 31, 2009	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
<i>(Dollars in thousands)</i>				
<b>Financial Assets:</b>				
Cash and cash equivalents	\$ 21,424	\$ 21,424	\$ 12,395	\$ 12,395
Securities	315,220	315,220	334,762	334,762
Loans held for sale	4,281	4,281	4,881	4,881
Loans, net	366,539	372,869	369,608	373,940
Derivative Assets	1,101	1,101	931	931
<b>Financial Liabilities:</b>				
Deposits	\$ 607,127	\$ 615,300	\$ 579,409	\$ 585,597
Short-term borrowings	2,685	2,685	15,960	15,960
Long-term debt	93,331	99,505	118,349	124,004
Derivative Liabilities	1,101	1,101	931	931

#### NOTE 18: RELATED PARTY TRANSACTIONS

A director of the Company is an officer in a construction company that the Company contracted with during the year ended December 31, 2009 for the construction of a new branch facility. Total payments made to the construction company under the terms of the construction contract were \$587 thousand for the years ended December 31, 2009. No payments were made to the construction company for the year ended December 31, 2010.

The Bank has made, and expects in the future to continue to make in the ordinary course of business, loans to directors and executive officers of the Company, the Bank, and their affiliates. In management's opinion, these loans were made in the ordinary course of business at normal credit terms, including interest rate and collateral requirements, and do not represent more than normal credit risk. An analysis of such outstanding loans is presented below.

	Amount
<i>(Dollars in thousands)</i>	
Loans outstanding at December 31, 2009	\$ 3,257
New loans/advances	2,650
Repayments	(1,859)
Changes in directors and executive officers	—
Loans outstanding at December 31, 2010	\$ 4,048

During 2010 and 2009, certain executive officers and directors of the Company and the Bank, including companies with which they are affiliated, were deposit customers of the bank. Total deposits for these persons at December 31, 2010 and 2009 amounted to \$18.7 million and \$17.8 million, respectively.

#### NOTE 19: REGULATORY RESTRICTIONS AND CAPITAL RATIOS

The Company and the Bank are subject to various regulatory capital requirements and policies administered by federal and State of Alabama banking regulators. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a material effect on the consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors, including anticipated capital needs, and the Federal Reserve is encouraging the maintenance of higher levels of capital well above the minimum ratios and is expected to propose higher capital requirements to implement the Dodd-Frank Act and Basel III capital requirements. Supervisory assessments of capital adequacy may differ significantly from conclusions based solely upon risk-based capital ratios. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) Tier 1 leverage capital ratio, Tier 1 risk-based ratio and total risk-based ratio. Management believes, as of December 31, 2010, that the Company and the Bank meet all capital

adequacy requirements to which they are subject.

As of December 31, 2010, the Bank is “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized,” the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. Management has not received any notification from the Company or the Bank's regulators that changes the Bank's regulatory capital status.

The actual capital amounts and ratios and the aforementioned minimums as of December 31, 2010 and 2009 are presented below.

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<i>(Dollars in thousands)</i>						
<b>At December 31, 2010:</b>						
Tier 1 Leverage Capital						
Auburn National Bancorporation	\$ 65,644	8.47%	\$ 30,999	4.00%	N/A	N/A
AuburnBank	61,707	8.00	30,835	4.00	\$ 38,544	5.00%
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	\$ 65,644	14.57%	\$ 18,017	4.00%	N/A	N/A
AuburnBank	61,707	13.82	17,863	4.00	\$ 26,795	6.00%
Total Risk-Based Capital						
Auburn National Bancorporation	\$ 71,269	15.82%	\$ 36,035	8.00%	N/A	N/A
AuburnBank	67,332	15.08	35,727	8.00	\$ 44,658	10.00%
<b>At December 31, 2009:</b>						
Tier 1 Leverage Capital						
Auburn National Bancorporation	\$ 63,176	8.13%	\$ 31,095	4.00%	N/A	N/A
AuburnBank	59,143	7.65	30,931	4.00	\$ 38,664	5.00%
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	\$ 63,176	13.73%	\$ 18,402	4.00%	N/A	N/A
AuburnBank	59,143	12.97	18,244	4.00	\$ 27,365	6.00%
Total Risk-Based Capital						
Auburn National Bancorporation	\$ 68,906	14.98%	\$ 36,803	8.00%	N/A	N/A
AuburnBank	64,873	14.22	36,487	8.00	\$ 45,609	10.00%

Dividends paid by the Bank are a principal source of funds available to the Company for payment of dividends to its stockholders and for other needs. Applicable federal and state statutes and regulations impose restrictions on the amounts of dividends that may be declared by the subsidiary bank. State law and Federal Reserve policy restrict the Bank from declaring dividends in excess of the sum of the current year's earnings plus the retained net earnings from the preceding two years without prior approval. In addition to the formal statutes and regulations, regulatory authorities also consider the adequacy of the Bank's total capital in relation to its assets, deposits, and other such items. Capital adequacy considerations could further limit the availability of dividends from the Bank. At December 31, 2010, the Bank could have declared additional dividends of approximately \$6.2 million without prior approval of regulatory authorities. As a result of this limitation, approximately \$53.4 million of the Company's investment in the Bank was restricted from transfer in the form of dividends.

**NOTE 20: AUBURN NATIONAL BANCORPORATION (PARENT COMPANY)**

The Parent Company's condensed balance sheet and related condensed statements of earnings and cash flows are as follows:

**CONDENSED BALANCE SHEETS**

	December 31	
	2010	2009
<i>(Dollars in thousands)</i>		
<b>Assets:</b>		
Cash and due from banks	\$ 804	\$ 765
Investment in bank subsidiary	59,534	59,254
Premises and Equipment	3,388	3,474
Other assets	575	591
Total assets	\$ 64,301	\$ 64,084
<b>Liabilities:</b>		
Accrued expenses and other liabilities	\$ 716	\$ 684
Long-term debt	7,217	7,217
Total liabilities	7,933	7,901
Stockholders' equity	56,368	56,183
Total liabilities and stockholders' equity	\$ 64,301	\$ 64,084

**CONDENSED STATEMENTS OF EARNINGS**

	Years ended December 31		
	2010	2009	2008
<i>(Dollars in thousands)</i>			
<b>Income:</b>			
Dividends from bank subsidiary	\$ 3,085	\$ 3,014	\$ 3,136
Noninterest income	417	445	307
Total income	3,502	3,459	3,443
<b>Expense:</b>			
Interest expense	236	236	397
Noninterest expense	577	587	526
Total expense	813	823	923
Earnings before income tax benefit and equity in undistributed earnings of bank subsidiary	2,689	2,636	2,520
Income tax benefit	(65)	(97)	(214)
Earnings before equity in undistributed earnings of bank subsidiary	2,754	2,733	2,734
Equity in undistributed (distributed) earnings of bank subsidiary	2,592	(329)	3,903
<b>Net earnings</b>	\$ 5,346	\$ 2,404	\$ 6,637

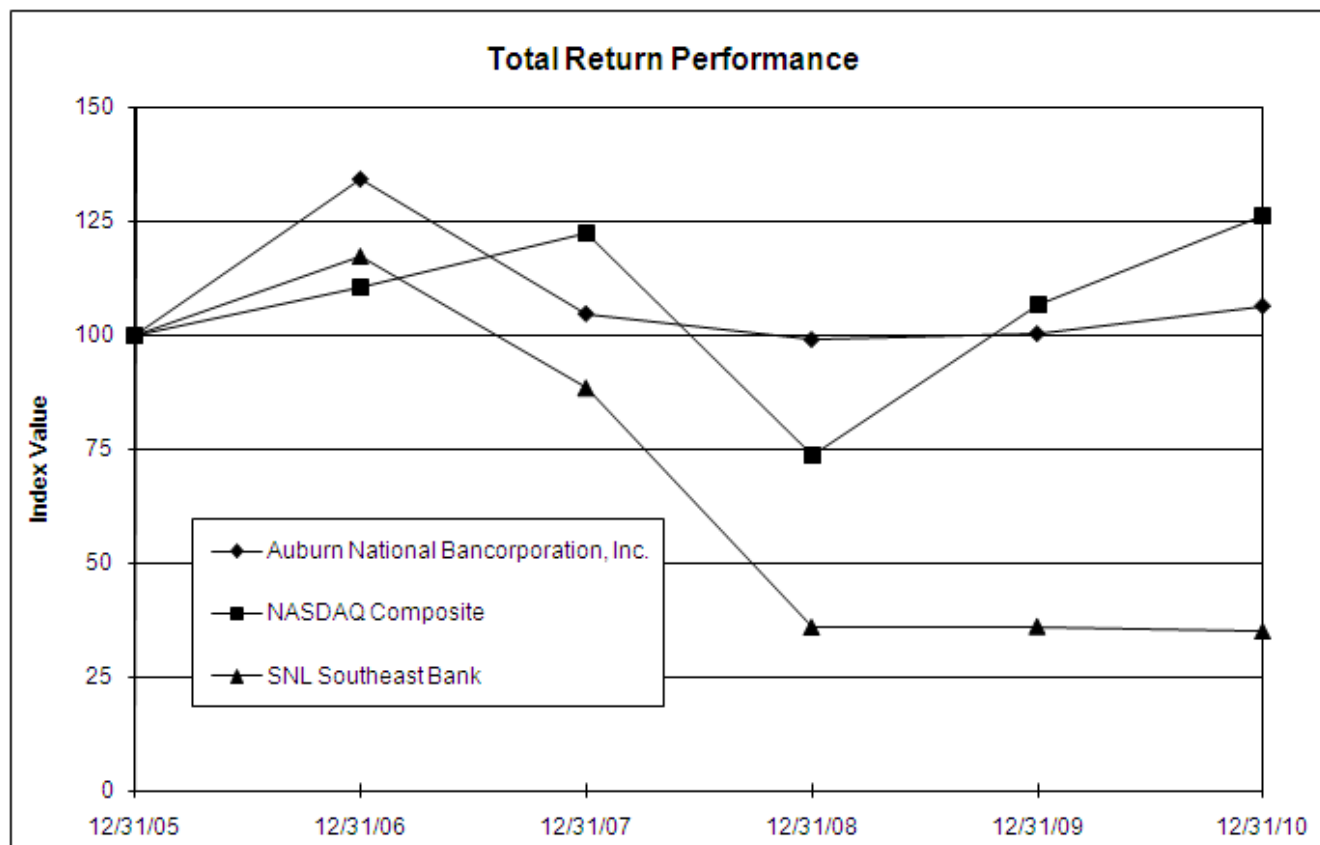
## CONDENSED STATEMENTS OF CASH FLOWS

<i>(Dollars in thousands)</i>	Years ended December 31		
	2010	2009	2008
<b>Cash flows from operating activities:</b>			
Net earnings	\$ 5,346	\$ 2,404	\$ 6,637
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	106	105	110
Loss on sale of premises and equipment	—	—	142
Net decrease (increase) in other assets	16	11	(38)
Net increase (decrease) in other liabilities	32	(78)	(113)
Equity in (undistributed) distributed earnings of bank subsidiary	(2,592)	329	(3,903)
Net cash provided by operating activities	2,908	2,771	2,835
<b>Cash flows from investing activities:</b>			
Purchases of premises and equipment	(20)	(4)	(6)
Proceeds from sale of premises and equipment	—	—	282
Net cash (used in) provided by investing activities	(20)	(4)	276
<b>Cash flows from financing activities:</b>			
Stock repurchases	(9)	(90)	(813)
Proceeds from sale of treasury stock	2	3	2
Dividends paid	(2,842)	(2,770)	(2,716)
Net cash used in financing activities	(2,849)	(2,857)	(3,527)
Net change in cash and cash equivalents	39	(90)	(416)
Cash and cash equivalents at beginning of period	765	855	1,271
<b>Cash and cash equivalents at end of period</b>	<b>\$ 804</b>	<b>\$ 765</b>	<b>\$ 855</b>

## STOCK PERFORMANCE GRAPH

The following performance graph and related information shall not be deemed “soliciting material” nor to be “filed” with the SEC, nor shall such information be incorporated by reference into any future filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, each as amended, except to the extent we specifically incorporate it by reference into such filing.

The following line-graph compares the cumulative, total return on the Company’s Common Stock from December 31, 2005 to December 31, 2010, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a \$100 investment on December 31, 2005). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.



Index	Period Ending					
	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10
Auburn National Bancorporation Inc.....	100.00	133.94	104.50	98.86	100.15	106.20
Nasdaq Composite Index .....	100.00	110.39	122.15	73.32	106.57	125.91
SNL Southeast Bank Index .....	100.00	117.26	88.33	35.76	35.90	34.86

# CORPORATE INFORMATION

## Corporate Headquarters

100 N. Gay Street  
P.O. Box 3110  
Auburn, AL 36831-3110  
Phone: 334-821-9200  
Fax: 334-887-2796  
[www.auburnbank.com](http://www.auburnbank.com)

## Independent Auditors

KPMG LLP  
Suite 1800  
420 20th Street N.  
Birmingham, AL 35203

## Shareholder Services

Shareholders desiring to change the name, address or ownership of Auburn National Bancorporation, Inc. common stock or to report lost certificates should contact our Transfer Agent:

Registrar and Transfer Company  
10 Commerce Drive  
Cranford, NJ 07016-3572  
Phone: 1-800-368-5948  
Fax: 1-908-497-2318  
e-mail: [info@rtco.com](mailto:info@rtco.com)

For frequently asked questions, visit the Transfer Agent's home page at [www.rtco.com](http://www.rtco.com)

## Annual Meeting

Tuesday, May 10, 2011  
3:00 p.m. (Central Time)  
AuburnBank Center  
132 N. Gay Street  
Auburn, AL 36830

## Investor Relations

A copy of the Company's annual report on Form 10-K, filed with the Securities and Exchange Commission (SEC), as well as our other SEC filings and our latest press releases are available free of charge through a link on our internet website at [www.auburnbank.com](http://www.auburnbank.com). Requests for these documents may also be made by emailing Investor Relations at [investorrelations@auburnbank.com](mailto:investorrelations@auburnbank.com) or by contacting Investor Relations by telephone or mail at the Company's corporate headquarters.

## Common Stock Listing

Auburn National Bancorporation, Inc.  
Common Stock is traded on the Nasdaq Global Market under the symbol AUBN.

## Dividend Reinvestment and Stock Purchase Plan

Auburn National Bancorporation, Inc. offers a Dividend Reinvestment Plan (DRIP) for automatic reinvestment of dividends in the stock of the company. Participants in the DRIP may also purchase additional shares with optional cash payments. For additional information or for an authorization form, please contact Investor Relations.

## Direct Deposit of Dividends

Dividends may be automatically deposited into a shareholder's checking or savings account free of charge. For more information, contact Investor Relations.



**AUBURNBANK**

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100 N. Gay Street, P.O. Box 3110, Auburn, AL 36831-3110  
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