



AUBURN BANK

AUBURN NATIONAL BANCORPORATION, INC.

2012 ANNUAL REPORT

Auburn Ala  
Jan 3rd 1907

at a meeting of the stock-  
holders of the Bank of Auburn  
40% of the Capital Stock \$10000.00  
was paid in. The following officers  
and directors were elected for the  
 ensuing year. Wm E Hallaway  
President. W L Mountain Cashier.  
Directors:- Wm E Hallaway, Thos  
Morgan, B B Ross, Dr C A Cory,  
Dr O W Spadhaun, J L Doomer,  
H P Luper, J O Wright.  
There being no further business  
the stockholders adjourned,

Wm E Hallaway Chmn  
W L Mountain Secy

A LEGACY *of* SERVICE



AUBURN BANK

AUBURN NATIONAL BANCORPORATION, INC.

2012 ANNUAL REPORT

## TO OUR SHAREHOLDERS AND FRIENDS

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A century plus! This is right — for 106 years AuburnBank has been here to provide financial services to the citizens, the businesses, and the institutions of our area.

We started because there was a need and a realization that a bank was essential for everyday commerce, the well-being of our neighbors, and growth. It is an understatement to say we had a meager beginning with \$10,000 in paid in capital. But it was enough and from that modest base we have grown to three quarters of a billion dollars in assets and a very strong Tier 1 Capital of \$72.0 million.

As you will see from the numbers in this report, 2012 was a good year — second best ever in net income, four hundred million in loans, strong reserves, and a determination to take care of our customers and the communities in which we have a presence.

In Auburn we have full service banks downtown and at Bent Creek and our full service bank in Opelika is located downtown on 6th street. For your convenience in both communities we have in-store branches in the Wal-Mart and Kroger stores. We are pleased that our new full service facility is now open on Fob James Drive in the Valley and it has an active and growing customer base.

Several years ago we expanded our service area by locating banks in Notasulga and Hurtsboro. Our neighbors needed us and we responded.

And that is what we have been doing for 106 years. We are here to help you and the results are evident.

Our officers and our staff are capable, dedicated, and determined to provide the service and help that you need.

We appreciate the loyalty and support of our owners and customers and we look forward to another rewarding year.



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





## CORPORATE PROFILE

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During 2012, AuburnBank continued to focus on sound banking practices, yielding excellent financial performance. In spite of challenging credit conditions, AuburnBank significantly exceeded last year's bottom line and continued to strengthen its capital position.

These results produced earnings per share of \$1.86, matching our previous record. Our net interest margin increased 26 basis points and our loan portfolio increased approximately \$28 million, or 8 percent. In addition, our non-performing assets declined by \$2.8 million, or 15 percent, and we increased our dividend payment to shareholders. On an annual basis, the cash dividend paid to shareholders has increased 16 of the last 17 years.

We also completed the construction of our new Super Six drive-up teller facility which opened October 1st. Located on the main bank campus, the new Super Six has five drive-up windows, a drive-up ATM, and a walk-up teller window. To facilitate better traffic flow, the bank has new entrances and exits on both Magnolia Avenue and Gay Street and an exit on Burton Street. Additional work on the bank's main campus parking lot continues and will provide new parking areas and easier access to the main office and Center facilities.

An era in AuburnBank history ended in 2012 with the retirement of our Vice Chairman of the Board, Dr. Emil F. Wright, Jr. Three generations of Wrights have served the bank with distinction, including Dr. Wright's grandfather and father. For 40 years, Dr. Wright has provided many contributions to the success of AuburnBank through his loyal service and commitment to sound prudent advice that was good for the bank and the communities we serve. We extend our deepest appreciation to him and wish him the very best in the future.

AuburnBank is fortunate to be able to give back to the communities we serve. Throughout the markets we are located in, we remain involved in many local charities, special events, education, and opportunities for service, both at a corporate level and among individual employees. We are proud of the fact that the bank has enjoyed a long-term relationship among its customers and the communities we serve.

2013 will be another challenging year. We will continue to 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, Valley, Hurtsboro, and Notasulga, Alabama, as well as the 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. Loan offices are also located in Phenix City and Montgomery, 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



# A LEGACY *of* SERVICE

The 2012 retirement of Dr. Emil F. Wright, Jr. from the AuburnBank Board of Directors marked the end of an era. Since the bank's inception, three generations of the Wright family have helped guide the bank throughout its 106-year history, integrating core values and practices like integrity, humility, innovation and visionary leadership.



Above: Thomas Oscar Wright  
Left: Emil F. Wright Sr.



"I had the good fortune to serve with Emil for 38 of his 40 years on the board. He was a thoughtful, dedicated director, and we have all benefited from his board membership. He will be missed, and we greatly appreciate all of his efforts and contributions," says E.L. Spencer, Jr., Chairman of the Board.

"I was just getting the hang of being a director when I retired," laughs Wright, humble when hearing accolades regarding his contributions. "Directors do their best work when they stay out of the way. The key is to let the ones who know the business, do what they do best."

Wright might underplay his contributions, but banking flowed generationally through his blood. The Wrights' footprint at AuburnBank began with his grandfather, Thomas Oscar Wright, a local farmer who was one of the bank's founding directors in 1907. His father, Emil Wright, Sr., became the bank's third president in 1957 after joining the staff in 1928.

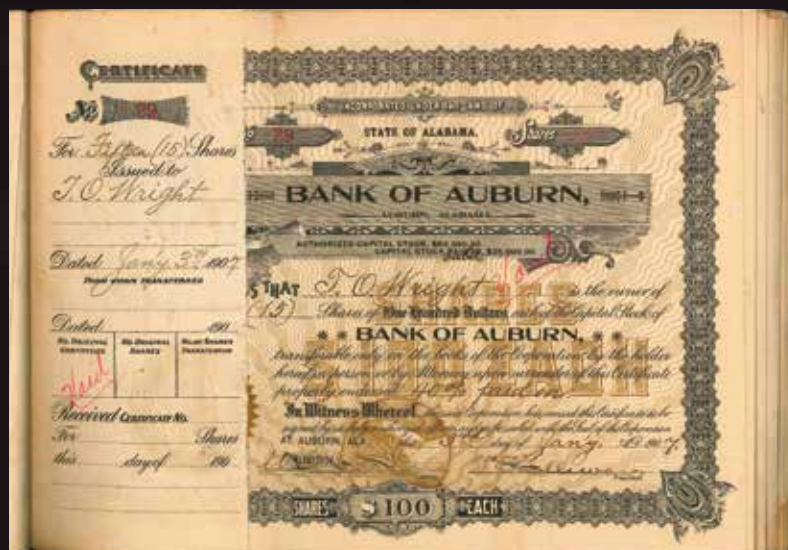
Before joining the AuburnBank Board in 1973, Dr. Wright graduated from the Massachusetts Institute of Technology with a B.S. in Geology and Geophysics. After a tour in the Navy, Dr. Wright graduated from Emory University School of Medicine. He then returned to the Navy Medical Corps for an internship and completed his residency at Emory in ophthalmology. His medical career began in Auburn in 1971

where he was a highly respected ophthalmologist serving the Auburn-Lee County area for 29 years. His service in the medical field included four trips to third-world countries where he performed cataract surgery on many indigent blind patients. In addition to raising a family, he and his wife Margaret remain actively involved in many civic, charitable and church activities in the Auburn community.

Like his father and grandfather, Wright applied his love of learning and commitment to "helping others" during his tenure at AuburnBank. Service on the loan committee and others taught him the fundamental importance of the bank in helping the community grow by providing for its credit needs. At various times, he served on other bank committees such as asset/liability, information technology, executive, compensation/personnel, strategic planning and audit.

Wright supported the AuburnBank tradition of serving the community while leading the industry in innovative banking methods. He had the foresight to recognize the importance of the computer. "When I started on the board, loan records were kept on 5 x 7 cards. Not much structure to the loan committees back then." Wright learned about the technology and, understanding its impact, supported the continuing effort of integrating technology into banking. During this period,

Under business the meeting  
*Emil F. Wright*  
 Secretary.



Above: Bank of Auburn stock certificate issued to T. O. Wright on January 3rd, 1907.

Seated left to right: R. F. Blake, B. F. Thomas, Sr., H. R. Hubbard, and E. L. Spencer, Sr.  
 Standing: A. D. Lipscomb, Jr., P. C. Hudson, Emil F. Wright, Jr., and Knox M. McMillan



AuburnBank was the first in the community to introduce the Automated Teller Machine and the first free-standing drive-thru teller in the area.

One of Dr. Wright's memories is the Kopper Kettle explosion in January 1978. This event had a profound effect on the community and the bank. That Sunday morning dawned cold and quiet. Churchgoers had yet to venture into town, and AuburnBank on Magnolia sat silent and empty. The Kopper Kettle, an eatery serving burgers, chili, and pie, suddenly

exploded into flames causing enormous damage to all the businesses in downtown Auburn. The bank, directly across the street from the restaurant, sustained considerable damage.

Everyone in the bank—staff, officers and directors—worked all day Sunday cleaning up the bank while maintaining security and helping the neighboring businesses emerge from the rubble. Wright was quoted in the bank's 100-year-anniversary book *More than Money*, "It was a matter of pride." Amid the destruction and reconstruction, tellers worked in the freezing cold, and the bank opened for business on Monday morning.

For more than 100 years, AuburnBank has consistently maintained a tradition of a people-first, common-sense approach to banking. With board members like Dr. Wright, his father and grandfather, the bank has weathered a depression, recessions, busts and booms in sound financial condition. During Wright's tenure, the bank's total assets grew from just over \$22 million in 1973 to over \$760 million at the time of his retirement.

"Retiring was a tough decision to make," states Dr. Wright, "but the timing was right. AuburnBank will always hold a special place in my heart and I will continue to be a loyal customer and shareholder."

Bob Dumas, current president of AuburnBank, knows the legacy Dr. Wright has left as a board member. "It has been a pleasure and privilege to serve with Dr. Wright on our Board of Directors. His loyal service and many contributions to AuburnBank will continue to benefit the bank and the communities we serve for many years to come. We extend our deepest appreciation to Dr. Wright for his service and wish him the very best in his retirement. Dr. Wright's retirement may mark the end of an era, but the Wright family has made a lasting impact."

To commemorate Dr. Wright's retirement from AuburnBank's Board of Directors, Chairman E. L. Spencer, Jr., presents Dr. Wright with a plaque that has photos of the Board both when Dr. Wright first started with the Board (1973) and when he retired in 2012. Also, there is a statement of appreciation.





# New Super Six

The new Super Six was opened for business October 1, 2012. It features five drive-up windows, a drive-up ATM, and a walk-up teller window. To facilitate better traffic flow, the bank has new entrances and exits on both Magnolia Avenue and Gay Street as well as an exit on Burton Street.



AuburnBank President Bob Dumas cuts the ribbon at the new Super Six opening.



Bob Dumas congratulates long-time customer John F. Meagher for being the first person to use the new Super Six facility. Mr. Meagher's grandson, Thomas Meagher, accompanied his grandfather for the first transaction.



# AUBURN NATIONAL BANCORPORATION, INC. AND AUBURNBANK BOARD OF DIRECTORS



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

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  
City President, Valley Branch

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

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

Charlotte Lang  
Assistant Bank Secrecy  
Act Officer  
and Operations Officer

Woody Odom  
Information Systems Officer

Marcia Otwell  
Shareholder Relations and  
Administrative Officer

Jeff Stewart  
Assistant Vice President,  
Consumer Loan Officer

Christy A. Fogle  
Assistant Vice President,  
Loan Review Officer

Sam S. Rainer  
Marketing Officer

James R. Pack  
Vice President,  
Financial Reporting

Bruce Emfinger  
Commercial/Consumer  
Loan Officer

## OPELIKA BRANCH ADVISORY BOARD



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

William H. Brown  
President, Brown Agency, Inc.

William G. Dias  
Businessman

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

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 Executive,  
Craftmaster Printers, Inc.

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

## VALLEY BRANCH ADVISORY BOARD



Seated left to right: Valerie G. Gray, Terrell E. Bishop, and H. David Ennis, Sr.  
Standing: Roy W. McClendon, Jr., Claude E. (Skip) McCoy, Jr., Frank P. Norman and John H. Hood, II

Terrell E. Bishop  
Senior Vice President,  
Senior Mortgage Loan Officer  
City President, Valley Branch

H. David Ennis, Sr.  
President, Novelli-Ennis & Company,  
CPAs

Valerie G. Gray  
Executive Director of the Chambers  
County Development Authority

John H. Hood, II  
Pharmacist, Hood's Pharmacy

Roy W. McClendon, Jr.  
Retired Pharmacist

Claude E. (Skip) McCoy, Jr.  
Attorney, Johnson, Caldwell &  
McCoy Law Firm

Frank P. Norman  
Owner, Johnny's New York Style  
Pizza and WingStop



# FINANCIAL HIGHLIGHTS

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

	For the Years Ended December 31,				
	2012	2011	2010	2009	2008
<b>Earnings</b>					
Net Interest Income	\$20,897	\$19,225	\$18,899	\$18,815	\$17,870
Provision for Loan Losses	3,815	2,450	3,580	5,250	870
Net Earnings	6,763	5,538	5,346	2,404	6,637
Per Share:					
Net Earnings	1.86	1.52	1.47	0.66	1.81
Cash Dividends	0.82	0.80	0.78	0.76	0.74
Book Value	19.26	17.96	15.47	15.42	15.66
Shares Issued	3,957,135	3,957,135	3,957,135	3,957,135	3,957,135
Weighted Average Shares Outstanding	3,642,831	3,642,735	3,642,851	3,644,691	3,674,384
<b>Financial Condition</b>					
Total Assets	759,833	776,218	763,829	\$773,382	\$745,970
Loans, net of unearned income	398,193	370,263	374,215	376,103	369,162
Investment Securities	259,475	299,582	315,220	334,762	302,656
Total Deposits	636,817	619,552	607,127	579,409	550,843
Long Term Debt	47,217	85,313	93,331	118,349	123,368
Stockholders' Equity	70,149	65,416	56,368	56,183	57,128
<b>Selected Ratios</b>					
Return on Average Total Assets	0.90%	0.72%	0.68%	0.31%	0.92%
Return on Average Total Equity	9.85%	9.10%	9.00%	4.23%	12.18%
Average Stockholders' Equity to Average Assets	9.09%	7.89%	7.61%	7.21%	7.59%
Allowance for Loan Losses as a % of Loans	1.69%	1.87%	2.05%	1.73%	1.19%
Loans to Total Deposits	62.53%	59.76%	61.64%	64.91%	67.01%



**AUBURN BANK**

SINCE 1907  
YOUR PARTNER, YOUR NEIGHBOR,  
YOUR FRIEND

**Financial Section**

Auburn National Bancorporation, Inc. 2012 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; (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 2012 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. (the “Company”) is a bank holding company registered with the Board of Governors of the Federal Reserve System (the “Federal Reserve”) under the Bank Holding Company Act of 1956, as amended (the “BHC Act”). The Company was incorporated in Delaware in 1990, and in 1994 it succeeded its Alabama predecessor as the bank holding company controlling AuburnBank, an Alabama state member bank with its principal office in Auburn, Alabama (the “Bank”). The Company and its predecessor have controlled the Bank since 1984. As a bank holding company, the Company may diversify into a broader range of financial services and other business activities than currently are permitted to the Bank under applicable laws, regulations and rules. The holding company structure also provides greater financial and operating flexibility than is presently permitted to the Bank.

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 or incorporated 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. The Bank’s primary service area 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 13 locations in its primary service area. 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. We apply these standards at the time a loan is made and monitor them 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 primary service area. 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 primary service area, 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 primary service area also is subject to both local and national economic conditions and fluctuations. While most loans are made within our primary service area, residential mortgage loans are originated outside the primary service area, and the Bank from time to time has purchased loans and loan participations from outside its primary service area.

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

The following is a discussion of our financial condition at December 31, 2012 and 2011 and our results of operations for the years ended December 31, 2012, 2011, and 2010. 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".

### 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, Notasulga and Valley, 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. Loan production offices are located in Montgomery and Phenix City, Alabama.

### Summary of Results of Operations

	Year ended December 31		
<i>(Dollars in thousands, except per share data)</i>	2012	2011	2010
Net interest income (a)	\$ 22,539	\$ 20,944	\$ 20,664
Less: tax-equivalent adjustment	1,642	1,719	1,765
Net interest income (GAAP)	20,897	19,225	18,899
Noninterest income	10,483	5,177	6,718
Total revenue	31,380	24,402	25,617
Provision for loan losses	3,815	2,450	3,580
Noninterest expense	19,383	16,357	15,893
Income tax expense	1,419	57	798
Net earnings	\$ 6,763	\$ 5,538	\$ 5,346
Basic and diluted earnings per share	\$ 1.86	\$ 1.52	\$ 1.47

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

### Financial Summary

The Company's net earnings were \$6.8 million, or \$1.86 per share, for the full year 2012, compared to \$5.5 million, or \$1.52 per share, for the full year 2011.

Tax-equivalent net interest income increased 8% in 2012 from 2011 as improvement in the Company's net interest margin offset a decrease in average total interest earning assets in 2012 compared to 2011. Average total interest earning assets decreased 1% in 2012 when compared to 2011 as cash proceeds from securities sold, called, and matured in 2012 were used to reduce the level of wholesale funding (such as brokered certificates of deposit and FHLB advances) on our balance sheet. The decline in the average balance of the securities portfolio in 2012 was largely offset by growth in the loan portfolio. Average loans were \$391.3 million in 2012, an increase of 5%, compared to 2011. Average loans increased in 2012 compared to 2011 due to increased loan demand and an expanded market presence in Valley, Alabama.

The provision for loan losses was \$3.8 million for 2012, compared to \$2.5 million in 2011. The increase in the provision for loan losses was primarily due to an increase in net charge-offs and loan portfolio growth. Net charge-offs were \$4.0 million for 2012, compared to \$3.2 million in 2011. This increase was primarily due to an increase in net charge-offs in the commercial real estate portfolio of \$2.7 million, which was partially offset by declines in net charge-offs of \$1.6 million and \$0.4 million, respectively, in the construction and land development and commercial and industrial portfolios. In both 2012 and 2011, net charge-offs were affected by a few individually significant charge-offs. In 2012, the Company



charged off \$3.1 million related to three borrowing relationships. In 2011, the Company charged off \$2.5 million related to three borrowing relationships. Overall, the Company's net charge-off ratio was 1.03% in 2012, compared to 0.86% in 2011.

Noninterest income was \$10.5 million in 2012, compared to \$5.2 million in 2011. The increase in noninterest income was primarily due to an increase in mortgage lending income of \$1.5 million and a \$3.3 million gain on sale of three affordable housing investments in January 2012.

Noninterest expense was \$19.4 million in 2012, compared to \$16.4 million in 2011. On January 19, 2012, the Company restructured its balance sheet by paying off \$38.0 million of FHLB advances with a weighted average interest rate of 4.26% and a weighted average duration of 2.6 years. The increase in total noninterest expense in 2012 was primarily due to prepayment penalties of \$3.7 million incurred on the repayment of the FHLB advances, compared to none in 2011. Other changes impacting noninterest expense were an increase in salaries and benefits expense of \$0.5 million, an increase in other noninterest expense of \$0.7 million, and a decrease in net expenses related to other real estate owned of \$1.7 million.

Income tax expense for 2012 was \$1.4 million, compared to \$0.1 million in 2011. The Company's effective income tax rate was 17.34% in 2012, compared to 1.02% in 2011. The increase in the Company's effective tax rate was due to a 46% increase in the level of earnings before taxes and a decrease in federal tax credits related to the Company's investments in affordable housing limited partnerships, which were sold in January 2012. The impact of these changes on the Company's effective tax rate for the full year 2012 was partially reduced by the reversal of a previously established deferred tax asset valuation allowance of \$0.5 million related to capital loss carry-forwards.

In 2012, the Company paid cash dividends of \$3.0 million, or \$0.82 per share. The Company remains well capitalized under current regulatory guidelines with a total risk-based capital ratio of 17.46%, a tier one risk-based capital ratio of 16.20%, and a tier one leverage capital ratio of 9.58% at December 31, 2012.

### **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 OREO, 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 portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a 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 loss rates 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. Loans are charged off, in whole or in part, 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.

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. 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 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.

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In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal and independent loan review processes. 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 it 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, construction and land development, 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, 2012 and 2011, and for the years then ended, 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 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 regularly re-evaluates its practices in determining the allowance for loan losses. During the fourth quarter of 2011, the Company's management decided to eliminate a previously unallocated component of the allowance. As a result, the Company had no unallocated amount included in the allowance at December 31, 2011, compared to an unallocated amount of \$0.1 million, or 1.4% of the total allowance, at December 31, 2010.

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 economic conditions as of the applicable balance sheet date.

#### **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 for 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 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 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.

### **Fair Value Determination**

GAAP requires management to value and disclose certain of the Company's assets and liabilities at fair value, 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 accordance with 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 17, Fair Value, of the consolidated financial statements that accompany this report.

Fair values are based on active market prices of identical assets or liabilities when available. Comparable assets or liabilities or a composite of comparable assets in active markets are used when identical assets or liabilities do not have readily available active market pricing. However, some of the Company's assets or liabilities lack an available or comparable trading market characterized by frequent transactions between willing buyers and sellers. In these cases, fair value is 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 and 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 of OREO are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. 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 OREO.

### **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 we will realize the benefits of these deductible differences at December 31, 2012. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

## Average Balance Sheet and Interest Rates

	Year ended December 31					
	2012		2011		2010	
	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
<i>(Dollars in thousands)</i>						
Loans and loans held for sale	\$ 395,938	5.54%	\$ 376,000	5.67%	\$ 380,552	5.73%
Securities - taxable	199,794	1.94%	223,638	2.69%	246,610	3.33%
Securities - tax-exempt (a)	77,447	6.24%	79,329	6.37%	81,256	6.39%
Total securities	277,241	3.14%	302,967	3.65%	327,866	4.09%
Federal funds sold	27,466	0.20%	28,905	0.19%	13,984	0.21%
Interest bearing bank deposits	793	—	1,394	0.05%	1,076	0.09%
Total interest-earning assets	701,438	4.38%	709,266	4.57%	723,478	4.87%
Deposits:						
NOW	99,664	0.35%	90,565	0.58%	88,070	0.69%
Savings and money market	153,668	0.56%	138,428	0.72%	117,725	1.04%
Certificates of deposits less than \$100,000	108,726	1.63%	114,490	1.95%	113,912	2.42%
Certificates of deposits and other time deposits of \$100,000 or more	161,128	2.08%	181,242	2.38%	197,387	2.76%
Total interest-bearing deposits	523,186	1.21%	524,725	1.54%	517,094	1.94%
Short-term borrowings	2,970	0.54%	2,423	0.50%	3,530	0.65%
Long-term debt	49,115	3.73%	86,899	3.91%	112,312	4.02%
Total interest-bearing liabilities	575,271	1.42%	614,047	1.87%	632,936	2.30%
Net interest income and margin (a)	\$ 22,539	3.21%	\$ 20,944	2.95%	\$ 20,664	2.86%

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

## RESULTS OF OPERATIONS

### Net Interest Income and Margin

#### 2012 vs. 2011 comparison

Net interest income (tax-equivalent) was \$22.5 million in 2012, compared to \$20.9 million in 2011, as net interest margin improvement offset a decline in average interest-earning assets of 1%. Net interest margin (tax-equivalent) was 3.21% in 2012, compared to 2.95% in 2011. The improved net interest margin reflected management's efforts to increase earnings by shifting the Company's asset mix through loan growth, focusing on deposit pricing, and repaying higher-cost wholesale funding sources. The cost of total interest-bearing liabilities decreased 45 basis points in 2012 from 2011 to 1.42%. The net decrease was largely the result of the continued shift in our deposit mix, as we increased our lower-cost noninterest-bearing demand deposits, interest bearing demand deposits (NOW accounts), and savings and money market accounts and concurrently reduced balances of higher-cost certificates of deposit and other higher-cost time deposits and long-term debt (i.e. wholesale funding).

The tax-equivalent yield on total interest-earning assets decreased by 19 basis points in 2012 from 2011 to 4.38%. This decrease was primarily driven by a 51 basis point reduction in the tax-equivalent yield on total securities to 3.14% as reinvestment yields in the securities portfolio declined due to the continued low interest rate environment. Also, loan pricing for creditworthy borrowers continues to be competitive in our markets and has limited the Company's ability to increase yields on new and renewed loans.

The Company continues to deploy various asset liability management strategies to manage its risk to interest rate fluctuations. The Company's net interest margin could experience pressure due to lower reinvestment yields in the securities portfolio given the current interest rate environment, increased pricing competition for quality loan opportunities, and fewer opportunities to further reduce our cost of funds due to the already low level of deposit rates currently.

#### 2011 vs. 2010 comparison

Net interest income (tax-equivalent) was \$20.9 million in 2011, compared to \$20.7 million in 2010, as net interest margin improvement offset a decline in average interest-earning assets of 2%. Net interest margin (tax-equivalent) was 2.95% in 2011, compared to 2.86% in 2010. The improved net interest margin reflected management's efforts to increase earnings by focusing on deposit pricing and repaying higher-cost wholesale funding sources. The cost of total interest-

bearing liabilities decreased 43 basis points in 2011 from 2010 to 1.87%. The net decrease was largely the result of the continued shift in our deposit mix, as we increased our lower-cost noninterest-bearing demand deposits, interest bearing demand deposits (NOW accounts), and savings and money market accounts and concurrently reduced balances of higher-cost certificates of deposit and other higher-cost time deposits and long-term debt (i.e. wholesale funding).

The tax-equivalent yield on total interest-earning assets decreased by 30 basis points in 2011 from 2010 to 4.57%. This decrease was primarily driven by a 44 basis point reduction in the tax-equivalent yield on total securities to 3.65% as reinvestment yields in the securities portfolio declined due to the low interest rate environment.

### 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 \$3.8 million, \$2.5 million, and \$3.6 million for the years ended December 31, 2012, 2011, and 2010, respectively.

The provision for loan losses increased in 2012 compared to 2011 due to an increase in net charge-offs and loan portfolio growth. Net charge-offs were \$4.0 million for 2012, compared to \$3.2 million in 2011. This increase was primarily due to an increase in net charge-offs in the commercial real estate loan portfolio of \$2.7 million, which was partially offset by declines in net charge-offs of \$1.6 million and \$0.4 million, respectively, in the construction and land development and commercial and industrial loan portfolios.

The provision for losses declined in 2011 compared to 2010 due to a decline in the level of allowance for loan losses related to the construction and land development portfolio segment. The decline in the allowance for loan losses was due to declines in total construction and development loans outstanding as well as a decline in adversely risk-graded 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 decreased to 1.69% at December 31, 2012 from 1.87% at December 31, 2011. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses should be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2012. 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 based on estimates and judgment and are therefore approximate and imprecise. Factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions exist which may negatively and materially affect our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

### Noninterest Income

<i>(Dollars in thousands)</i>	Year ended December 31		
	2012	2011	2010
Service charges on deposit accounts	\$ 1,111	\$ 1,167	\$ 1,280
Mortgage lending	3,445	1,922	2,494
Bank-owned life insurance	445	460	452
Gain on sale of affordable housing investments	3,268	—	—
Affordable housing investment losses	—	(646)	(323)
Securities gains, net	679	878	1,423
Other	1,535	1,396	1,392
Total noninterest income	\$ 10,483	\$ 5,177	\$ 6,718

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, net, 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, which are netted against the commission expense associated with these originations. The Company's normal practice is to originate mortgage loans for sale in the secondary market and to either sell 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.



MSRs are also evaluated for impairment periodically. Impairment is determined by grouping MSRs by common predominant characteristics, such as interest rate and loan type. If the aggregate carrying amount of a particular group of MSRs exceeds the group's aggregate fair value, a valuation reserve for that group is established. The valuation reserve is adjusted as the fair value changes. An increase in mortgage interest rates typically results in an increase in the fair value of the MSRs while a decrease in mortgage interest rates typically results in a decrease in the fair value of MSRs.

The following table presents a breakdown of the Company's mortgage lending income for 2012, 2011, and 2010.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2012	2011	2010
Origination income	\$ 3,430	\$ 1,680	\$ 2,143
Servicing fees, net	284	359	351
Increase in MSR valuation allowance	(269)	(117)	—
Total mortgage lending income	\$ 3,445	\$ 1,922	\$ 2,494

#### 2012 vs. 2011 comparison

Service charges on deposit accounts were \$1.1 million in 2012, compared to \$1.2 million in 2011. The decrease is primarily due to a decline in insufficient funds charges, reflecting changes in customer behavior and spending patterns.

Mortgage lending income was \$3.4 million in 2012, compared to \$1.9 million in 2011. A increase in the level of mortgage refinance activity during 2012 when compared to the levels experienced during 2011 contributed to the increase 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 Company recognized a gain on sale of \$3.3 million related to the sale of its interests in three affordable housing limited partnerships in January 2012. Accordingly, the Company did not receive any federal tax credits related to affordable housing partnership investments in 2012. Prior to the sale of these interests, the Company accrued its pro-rata share of partnership losses in noninterest income. In 2011, the Company accrued approximately \$0.6 million related to affordable housing investment losses.

The net gain on securities was \$0.7 million in 2012, compared to a net gain of \$0.9 million in 2011. Gross realized gains of \$1.0 million in 2012 were reduced by gross realized losses of \$0.2 million and other-than-temporary impairment charges of \$0.1 million related to trust preferred securities. Gross realized gains of \$1.7 million in 2011 were reduced by gross realized losses of \$0.5 million and \$0.3 million in other-than-temporary impairment charges related to trust preferred securities.

#### 2011 vs. 2010 comparison

Service charges on deposit accounts were \$1.2 million in 2011, compared to \$1.3 million in 2010. The decrease is primarily due to a decline in insufficient funds charges, reflecting changes in customer behavior and spending patterns.

Mortgage lending income was \$1.9 million in 2011, compared to \$2.5 million in 2010. A decline in the level of mortgage refinance activity during 2011 when compared to the levels experienced during 2010 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.

Losses related to affordable housing partnership investments were \$0.6 million in 2011, compared to \$0.3 million in 2010. The increase in losses on affordable housing partnership investments was primarily due to the Company's increased total investment in these projects in 2011. While the losses incurred by the partnerships are recognized in pre-tax earnings, these investments are designed to generate a return primarily through the realization of federal tax credits. As a result, these investments significantly reduced the Company's income tax expense during 2011 when compared to 2010.

The net gain on securities was \$0.9 million in 2011, compared to a net gain of \$1.4 million in 2010. Gross realized gains of \$1.7 million in 2011 were reduced by gross realized losses of \$0.5 million and other-than-temporary impairment charges of \$0.3 million related to trust preferred securities. Gross realized gains of \$3.5 million in 2010 were primarily reduced by approximately \$2.0 million in other-than-temporary impairment charges related to trust preferred securities and corporate debt securities.

**Noninterest Expense**

<i>(Dollars in thousands)</i>	Year ended December 31		
	2012	2011	2010
Salaries and benefits	\$ 8,691	\$ 8,167	\$ 7,402
Net occupancy and equipment	1,332	1,404	1,450
Professional fees	704	735	702
FDIC and other regulatory assessments	686	792	1,092
Other real estate owned, net	323	2,007	1,378
Prepayment penalty on long-term debt	3,720	—	679
Other	3,927	3,252	3,190
Total noninterest expense	\$ 19,383	\$ 16,357	\$ 15,893

2012 vs. 2011 comparison

Salaries and benefits expense was \$8.7 million in 2012, compared to \$8.2 million in 2011. The increase in 2012 when compared to 2011 reflected routine increases coupled with an increase in the number of full-time equivalent employees due to the opening of a new branch during December 2011 in Valley, Alabama.

FDIC and other regulatory assessments expense was \$0.7 million in 2012, compared to \$0.8 million in 2011. The decrease in 2012 when compared to 2011 was primarily due to the FDIC redefining the deposit insurance assessment base effective April 1, 2011. As a result, most FDIC insured institutions with less than \$10 billion in assets experienced a reduction in their FDIC deposit insurance assessments.

Other real estate owned expense, net was \$0.3 million in 2012, compared to \$2.0 million in 2011. The decrease was primarily due to a decline in realized holding losses or write-downs on the valuations of certain OREO properties. Despite the improvement in net expenses related to OREO, these properties could also be subject to future valuation adjustments as a result of updated appraisal information and further deterioration in real estate values, thus causing additional fluctuations in other real estate owned expense, net. Also, the Company will continue to incur expenses associated with maintenance costs and property taxes associated with these assets.

On January 19, 2012, the Company restructured its balance sheet by paying off \$38.0 million of FHLB advances with a weighted average interest rate of 4.26% and a weighted average duration of 2.6 years. In connection with repaying the FHLB advances, the Company incurred a \$3.7 million prepayment penalty in 2012, compared to none in 2011.

2011 vs. 2010 comparison

Salaries and benefits expense was \$8.2 million in 2011, compared to \$7.4 million in 2010. The increase in 2011 when compared to 2010 was primarily due to increased costs related to salaries, bonus compensation, and group medical insurance. No cash bonuses were accrued for Company or Bank officers in 2010.

FDIC and other regulatory assessments expense was \$0.8 million in 2011, compared to \$1.1 million in 2010. The decrease in 2011 when compared to 2010 was primarily due to the FDIC redefining the deposit insurance assessment base effective April 1, 2011. Most FDIC insured institutions with less than \$10 billion in assets experienced a reduction in their FDIC deposit insurance assessments during 2011.

Other real estate owned expense, net was \$2.0 million in 2011, compared to \$1.4 million in 2010. Approximately \$2.0 million and \$1.3 million of other real estate owned expense, net, in 2011 and 2010, respectively, related to realized holding losses or write-downs due to reduced valuations of certain OREO properties.

The Company incurred no prepayment penalties on long-term debt in 2011, compared to \$0.7 million in 2010. In 2010, the Company repaid \$10.0 million of securities sold under agreements to repurchase prior to their maturity that had been included in long-term debt.

## Income Tax Expense

### 2012 vs. 2011 comparison

Income tax expense for 2012 was \$1.4 million, compared to \$0.1 million in 2011. The Company's effective income tax rate was 17.34% in 2012, compared to 1.02% in 2011. The increase in the Company's effective tax rate was due to a 46% increase in the level of earnings before taxes and a decrease in federal tax credits related to the Company's investments in affordable housing limited partnerships, which were sold in January 2012. The impact of these changes on the Company's effective tax rate for the full year 2012 was partially reduced by the reversal of a previously established deferred tax asset valuation allowance of \$0.5 million related to capital loss carry-forwards. Excluding the reversal of the valuation allowance, the Company's effective tax rate for 2012 would have been approximately 23.51%.

### 2011 vs. 2010 comparison

In 2011, the Company recorded income tax expense of \$0.1 million, compared to \$0.8 million in 2010. The effective income tax rate was 1.02% in 2011, compared to 12.99% in 2010. The decrease in income tax expense and the effective tax rate from 2010 to 2011 was primarily due to a decrease in the level of earnings before taxes and an increase in federal tax credits related to the Company's increased investments in affordable housing limited partnerships in 2011.

## BALANCE SHEET ANALYSIS

### Securities

Securities available-for-sale were \$259.5 million and \$299.6 million as of December 31, 2012 and 2011, respectively. The decrease in securities available-for-sale of \$40.1 million, or 13%, was primarily due to management's efforts to limit the reinvestment of proceeds from sales, calls, and maturities of securities available-for-sale while long-term interest rates are at historically low levels by growing the loan portfolio and repaying wholesale borrowings (e.g. FHLB advances). Unrealized net gains on securities available-for-sale were \$8.2 million at December 31, 2012 compared to unrealized net gains of \$6.7 million at December 31, 2011. The increase in unrealized gains on securities available-for-sale was due to a decline in long-term interest rates and the narrowing of credit spreads. The average tax-equivalent yields earned on total securities were 3.14% in 2012 and 3.65% in 2011.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2012 according to contractual maturity. Actual maturities may differ from contractual maturities of residential mortgage-backed securities ("RMBS") because the mortgages underlying the securities may be called or prepaid with or without penalty.

December 31, 2012					
	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	\$ —	—	20,065	19,460	39,525
Agency RMBS	—	—	4,700	136,760	141,460
State and political subdivisions	111	1,830	21,006	54,891	77,838
Trust preferred securities	—	—	—	652	652
Total available-for-sale	\$ 111	1,830	45,771	211,763	259,475
<b>Weighted average yield:</b>					
Agency obligations	—	—	2.32%	2.33%	2.32%
Agency RMBS	—	—	1.86%	2.09%	2.09%
State and political subdivisions	2.76%	4.16%	4.05%	4.11%	4.09%
Trust preferred securities	—	—	—	1.86%	1.86%
Total available-for-sale	2.76%	4.16%	3.11%	2.62%	2.72%

**Loans**

	<b>December 31</b>				
<i>(In thousands)</i>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
Commercial and industrial	\$ 59,334	54,988	53,288	53,884	53,883
Construction and land development	37,631	39,814	47,850	56,820	67,420
Commercial real estate	183,611	162,435	166,241	156,928	132,818
Residential real estate	105,631	101,725	96,241	97,407	102,835
Consumer installment	12,219	11,454	10,676	11,236	12,463
Total loans	398,426	370,416	374,296	376,275	369,419
Less: unearned income	(233)	(153)	(81)	(172)	(257)
Loans, net of unearned income	\$ 398,193	370,263	374,215	376,103	369,162

Total loans, net of unearned income, were \$398.2 million as of December 31, 2012, an increase of \$27.9 million, or 8%, from \$370.3 million at December 31, 2011. Loan growth was primarily driven by an increase in commercial real estate loans of \$21.2 million from December 31, 2011. The majority of the increase in commercial real estate was due to an increase in multi-family residential and shopping center loans of \$13.5 million and \$6.7 million, respectively. Four loan categories represented the majority of the loan portfolio as December 31, 2012: commercial real estate mortgage loans (46%), residential real estate mortgage loans (27%), commercial and industrial loans (15%) and construction and land development loans (9%).

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately \$15.8 million, or 4%, and \$15.1 million, or 4%, of total loans, net of unearned income at December 31, 2012 and 2011, respectively. For residential real estate mortgage loans with a consumer purpose, approximately \$1.3 million and \$1.8 million required interest-only payments at December 31, 2012 and 2011, 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 \$3.1 million and \$3.8 million as of December 31, 2012 and 2011, 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 5.54% in 2012 and 5.67% in 2011.

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the effects of current 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 applicable 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 a bank's credit exposure by prohibiting unsecured loan relationships that exceed 10% of our Bank's capital accounts; or 20% of capital accounts, if loans in excess of 10% are fully secured. Under these regulations, we are prohibited from having unsecured loan relationships in excess of approximately \$15.4 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$13.8 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, 2012, 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 classification systems broadly accepted by the financial services industry in order to classify borrowers into various classifications. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank's total risk-based capital at December 31, 2012 (and related balances at December 31, 2011).

<i>(In thousands)</i>	<b>December 31</b>	
	<b>2012</b>	<b>2011</b>
Lessors of 1-4 family residential properties	\$ 47,544	\$ 43,767
Multi-family residential properties	30,392	16,935
Shopping centers	20,925	14,257
Office buildings	20,760	20,004

#### **Allowance for Loan Losses**

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company's estimate of probable losses in the loan portfolio. As of December 31, 2012 and 2011, respectively, the allowance for loan losses was \$6.7 million and \$6.9 million, respectively, which management believed 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, 2012 is presented below.

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>				
	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 6,919	7,676	6,495	4,398	4,105
Charge-offs:					
Commercial and industrial	(289)	(679)	(537)	(495)	(454)
Construction and land development	(231)	(1,758)	(1,487)	(2,088)	—
Commercial real estate	(3,184)	(422)	—	—	—
Residential real estate	(545)	(533)	(552)	(704)	(153)
Consumer installment	(85)	(21)	(111)	(61)	(98)
Total charge-offs	(4,334)	(3,413)	(2,687)	(3,348)	(705)
Recoveries:					
Commercial and industrial	54	34	63	47	102
Construction and land development	46	2	54	50	—
Commercial real estate	71	—	—	—	—
Residential real estate	134	155	151	92	6
Consumer installment	18	15	20	6	20
Total recoveries	323	206	288	195	128
Net charge-offs	(4,011)	(3,207)	(2,399)	(3,153)	(577)
Provision for loan losses	3,815	2,450	3,580	5,250	870
Ending balance	\$ 6,723	6,919	7,676	6,495	4,398
as a % of loans	1.69 %	1.87	2.05	1.73	1.19
as a % of nonperforming loans	64 %	67	65	69	99
Net charge-offs as a % of average loans	1.03 %	0.86	0.64	0.84	0.17

As noted under "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 1.69% at December 31, 2012, compared to

1.87% at December 31, 2011. 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 \$4.0 million, or 1.03% of average loans, in 2012, compared to net charge-offs of \$3.2 million, or 0.86%, in 2011. In both 2012 and 2011, net charge-offs were affected by a few individually significant charge-offs. In 2012, the Company charged off \$3.1 million related to three borrowing relationships. In 2011, the Company charged off \$2.5 million related to three borrowing relationships.

At December 31, 2012 and 2011, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 64% and 67%, respectively.

At December 31, 2012, the Company's recorded investment in loans considered impaired was \$10.5 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$0.3 million. At December 31, 2011, the Company's recorded investment in loans considered impaired was \$11.0 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$1.2 million.

Our regulators, as an integral part of their examination process, 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, 2012 the Company had \$15.5 million in nonperforming assets compared to \$18.3 million at December 31, 2011. Nonperforming assets decreased during 2012 due to continued efforts by management to reduce and resolve problem assets. The majority of the balance in nonperforming assets at December 31, 2012 related to deterioration in the commercial real estate and construction and land development loan portfolios.

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

	December 31				
(Dollars in thousands)	2012	2011	2010	2009	2008
<b>Nonperforming assets:</b>					
Nonperforming (nonaccrual) loans	\$ 10,535	10,354	11,833	9,352	4,431
Other real estate owned	4,919	7,898	8,125	7,292	324
<b>Total nonperforming assets</b>	<b>\$ 15,454</b>	<b>18,252</b>	<b>19,958</b>	<b>16,644</b>	<b>4,755</b>
as a % of loans and foreclosed properties	3.83 %	4.83	5.22	4.34	1.29
as a % of total assets	2.03 %	2.35	2.61	2.15	0.64
Nonperforming loans as a % of total loans	2.65 %	2.80	3.16	2.49	1.20
Accruing loans 90 days or more past due	\$ 58	—	—	5	104

The table below provides information concerning the composition of nonaccrual loans at December 31, 2012 and 2011, respectively.

	December 31	
(In thousands)	2012	2011
<b>Nonaccrual loans:</b>		
Commercial and industrial	\$ 60	76
Construction and land development	1,706	5,095
Commercial real estate	6,714	3,457
Residential real estate	2,055	1,726
<b>Total nonaccrual loans / nonperforming loans</b>	<b>\$ 10,535</b>	<b>10,354</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, 2012, the Company had \$10.5 million in loans on nonaccrual, compared to \$10.4 million at December 31, 2011.

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, or troubled debt restructurings ("TDRs"), 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 both December 31, 2012 and 2011, the Company had \$1.1 million in accruing TDRs.

At December 31, 2012 there were \$58,000 in loans 90 days past due and still accruing interest compared to none at December 31, 2011.

The table below provides information concerning the composition of OREO at December 31, 2012 and 2011, respectively.

	December 31	
	2012	2011
<i>(In thousands)</i>		
<b>Other real estate owned:</b>		
Commercial:		
Building	\$ 608	615
Developed lots	1,275	1,325
Residential:		
Condominiums	425	3,663
Undeveloped land	1,464	1,401
Other	1,147	894
<b>Total other real estate owned</b>	<b>\$ 4,919</b>	<b>7,898</b>

At December 31, 2012, the Company held \$4.9 million in OREO, which we acquired from borrowers, a decrease of \$3.0 million, or 38%, compared to December 31, 2011. At December 31, 2012, two properties made up approximately 50% of the balance in OREO, with a total carrying value of \$2.5 million. The decrease in OREO from December 31, 2011 primarily related to the disposal of the Company's participation interest in a completed condominium project on the Florida Gulf Coast, which had a carrying value of approximately \$2.3 million at December 31, 2011.

#### 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. This definition is believed to be substantially consistent with the standards established by the Federal Reserve, the Company's primary regulator, for loans classified as substandard, excluding nonaccrual loans. Potential problem loans, which are not included in nonperforming assets, amounted to \$12.6 million, or 3.2% of total loans at December 31, 2012, compared to \$18.5 million, or 5.0% of total loans at December 31, 2011. The decrease in potential problem loans was primarily due to one potential problem commercial real estate loan being placed on nonaccrual during the third quarter of 2012, which had a recorded investment of \$6.9 million at December 31, 2011.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The table below provides information concerning the composition of potential problem loans at December 31, 2012 and 2011, respectively.

(In thousands)	December 31	
	2012	2011
<b>Potential problem loans:</b>		
Commercial and industrial	\$ 563	719
Construction and land development	1,125	1,080
Commercial real estate	2,727	9,278
Residential real estate	7,978	7,311
Consumer installment	214	128
<b>Total potential problem loans</b>	<b>\$ 12,607</b>	<b>18,516</b>

At December 31, 2012, 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, 2012 and 2011, respectively.

(In thousands)	December 31	
	2012	2011
<b>Performing loans past due 30 to 89 days:</b>		
Commercial and industrial	\$ 173	1,191
Construction and land development	8	317
Commercial real estate	230	—
Residential real estate	1,537	1,245
Consumer installment	62	57
<b>Total performing loans past due 30 to 89 days</b>	<b>\$ 2,010</b>	<b>2,810</b>

### Deposits

(In thousands)	December 31	
	2012	2011
Noninterest bearing demand	\$ 118,014	106,276
NOW	96,332	88,438
Money market	124,676	113,077
Savings	34,600	30,400
Certificates of deposit under \$100,000	106,371	112,178
Certificates of deposit and other time deposits of \$100,000 or more	134,591	144,284
Brokered certificates of deposit	22,233	24,899
<b>Total deposits</b>	<b>\$ 636,817</b>	<b>619,552</b>

Total deposits were \$636.8 million and \$619.6 million at December 31, 2012 and 2011, respectively. The increase in total deposits of \$17.3 million reflects changes in customer preferences for short-term instruments in a low interest rate environment.

The average rates paid on total interest-bearing deposits were 1.21% in 2012 and 1.54% in 2011. Noninterest bearing deposits were 19% and 17% of total deposits as of December 31, 2012 and 2011, 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 with an original maturity of one year or less, and other short-term borrowings. The Bank had available federal fund lines totaling \$40.0 million with none outstanding at both December 31, 2012 and 2011. Securities sold under agreements to repurchase totaled \$2.7 million and \$2.8 million at December 31, 2012 and 2011, respectively.



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The average rates paid on short-term borrowings were 0.54% in 2012 and 0.50% in 2011. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the three-year period ended December 31, 2012 is included in Note 10 to the Consolidated Financial Statements included in this annual report.

Long-term debt includes 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 \$25.0 million and \$63.1 million in long-term FHLB advances at December 31, 2012 and 2011, respectively. On January 19, 2012, the Company restructured its balance sheet by paying off \$38.0 million of FHLB advances with a weighted average rate of 4.26% and a weighted average duration of 2.6 years. At both December 31, 2012 and 2011, the Company had \$15.0 million in securities sold under agreements to repurchase with an original maturity greater than one year and \$7.2 million in junior subordinated debentures related to trust preferred securities outstanding.

The average rates paid on long-term debt were 3.73% in 2012 and 3.91% in 2011.

## **CAPITAL ADEQUACY**

The Company's consolidated stockholders' equity was \$70.1 million and \$65.4 million as of December 31, 2012 and 2011, respectively. The increase in 2012 was primarily due to net earnings of \$6.8 million and other comprehensive income due to the change in unrealized gains (losses) on securities available-for-sale, net of tax, of \$1.0 million, which was reduced by cash dividends paid of \$3.0 million.

The Company's Tier 1 leverage ratio was 9.58%, Tier 1 risk-based capital ratio was 16.20% and Total risk-based capital ratio was 17.46% at December 31, 2012. 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 12 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, 2012.

Changes in Interest Rates	Net Interest Income % Variance
200 basis points	1.88 %
(200) basis points	NM

NM=not meaningful

At December 31, 2012, our earnings simulation model indicated a slightly asset-sensitive position over the next 12 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. The impact of rate scenarios assuming a gradual downward 200 basis point change in interest rates was not considered meaningful because of the historically low interest rate environment.

**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 re-pricing 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 25 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, 2012.

Changes in Interest Rates	EVE % Variance
200 basis points	(8.60)
(200) basis points	NM

NM=not meaningful

At December 31, 2012, the results of our EVE model would indicate that we are in compliance with our guidelines. 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. 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.

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, or that the predictions will be realized.

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. Depositor 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, 2012 and 2011, 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 opportunity cost of foregoing alternative higher-yielding investment opportunities.

Liquidity is managed at two levels: at the Company and at 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, 2012, the Bank had an available line of credit with the FHLB totaling \$226.2 million, with \$31.1 million outstanding (includes Advances and letters of credit). As of December 31, 2012, the Bank also had \$40.0 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, 2012, which by their terms had contractual maturity and termination dates subsequent to December 31, 2012:

		Payments due by period				
			1 year	1 to 3	3 to 5	More than
(Dollars in thousands)	Total	or less	years	years	5 years	
<b>Contractual obligations:</b>						
Deposit maturities (1)	\$	636,817	510,801	82,595	32,990	10,431
Long-term debt		47,217	—	15,000	20,000	12,217
Operating lease obligations		754	298	316	140	—
Total	\$	\$684,788	\$511,099	\$97,911	\$53,130	\$22,648

(1) Deposits with no stated maturity (demand, NOW, money market, and savings deposits) are presented in the "1 year or less" column

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 12 months.

### **Off-Balance Sheet Arrangements**

At December 31, 2012, the Bank had outstanding standby letters of credit of \$7.1 million and unfunded loan commitments outstanding of \$48.5 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.

#### *Mortgage lending activities*

Since 2009, we have primarily sold residential mortgage loans in the secondary market to Fannie Mae while retaining the servicing of these loans. The sale agreements for these residential mortgage loans with Fannie Mae and other investors include various representations and warranties regarding the origination and characteristics of the residential mortgage loans. Although the representations and warranties vary among investors, they typically cover ownership of the loan, validity of the lien securing the loan, the absence of delinquent taxes or liens against the property securing the loan, compliance with loan criteria set forth in the applicable agreement, compliance with applicable federal, state, and local laws, among other matters.

As of December 31, 2012, the unpaid principal balance of the residential mortgage loans, which we have originated and sold, but retained the servicing rights was \$326.4 million. Although these loans are generally sold on a non-recourse basis, except for breaches of customary seller representations and warranties, we may have to repurchase residential mortgage loans in cases where we breach such representations or warranties or the other terms of the sale, such as where we fail to deliver required documents or the documents we deliver are defective. Investors also may require the repurchase of a mortgage loan when an early payment default underwriting review reveals significant underwriting deficiencies, even if the mortgage loan has subsequently been brought current. Repurchase demands are typically reviewed on an individual loan by loan basis to validate the claims made by the investor and to determine if a contractually required repurchase event has occurred. We seek to reduce and manage the risks of potential repurchases or other claims by mortgage loan investors through our underwriting, quality assurance and servicing practices, including good communications with our residential mortgage investors.

In 2012, we repurchased one residential mortgage loan with an unpaid principal balance of \$0.3 million. This loan was current as to principal and interest at the time of repurchase, and we incurred no losses upon repurchase. We were not required to repurchase any residential mortgage loans in 2011 or 2010.

We service all residential mortgage loans originated and sold by us to Fannie Mae. As servicer, our primary duties are to: (1) collect payments due from borrowers; (2) advance certain delinquent payments of principal and interest; (3) maintain and administer any hazard, title, or primary mortgage insurance policies relating to the mortgage loans; (4) maintain any required escrow accounts for payment of taxes and insurance and administer escrow payments; and (5) foreclose on defaulted mortgage loans or take other actions to mitigate the potential losses to investors consistent with the agreements governing our rights and duties as servicer.

The agreement under which we act as servicer generally specifies a standard of responsibility for actions taken by us in such capacity and provides protection against expenses and liabilities incurred by us when acting in compliance with the respective servicing agreements. However, if we commit a material breach of our obligations as servicer, we may be subject to termination if the breach is not cured within a specified period following notice. The standards governing servicing and the possible remedies for violations of such standards are determined by servicing guides issued by Fannie Mae as well as the contract provisions established between Fannie Mae and the Bank. Remedies could include repurchase of an affected loan.

Although to date repurchase requests related to representation and warranty provisions, and servicing activities have been limited, it is possible that requests to repurchase mortgage loans may increase in frequency if investors more aggressively pursue all means of recovering losses on their purchased loans. As of December 31, 2012, we believe that this exposure is not material due to the historical level of repurchase requests and loss trends, in addition to the fact that 99.5% of our residential mortgage loans serviced for Fannie Mae were current as of such date. We maintain ongoing communications with our investors and will continue to evaluate this exposure by monitoring the level and number of repurchase requests as well as the delinquency rates in our investor portfolios.

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## Effects of Inflation and Changing Prices

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with GAAP 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

The following accounting pronouncements have been issued by the FASB, but are not yet effective:

- ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*.
- ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*.
- ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*.

Information about these pronouncements is described in more detail below.

ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, expands the disclosure requirements for financial instruments and derivatives that may be offset in accordance with enforceable master netting agreements or similar arrangements. The disclosures are required regardless of whether the instruments have been offset (or netted) in the statement of financial position. Under ASU 2011-11, companies must describe the nature of offsetting arrangements and provide quantitative information about those agreements, including the gross and net amounts of financial instruments that are recognized in the statement of financial position. In January 2013, the FASB issued ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*, which clarifies the scope of the offsetting disclosures and addresses any unintended consequences due to feedback from stakeholders that standard commercial provisions of many contracts would equate to a master netting arrangement. These changes are effective for the Company in the first quarter of 2013 with retrospective application. The Company does not expect the adoption of this Update will affect the Company's consolidated financial results since it amends only the disclosure requirements for offsetting financial instruments.

ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, seeks to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments in this Update will require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. GAAP to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. These changes are effective for the Company in the first quarter of 2013 with prospective application. The Company does not expect the adoption of this Update will have a significant impact on the financial statements of the Company.

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

In addition to results presented in accordance with 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.

	<b>2012</b>				<b>2011</b>			
	<b>Fourth Quarter</b>	<b>Third Quarter</b>	<b>Second Quarter</b>	<b>First Quarter</b>	<b>Fourth Quarter</b>	<b>Third Quarter</b>	<b>Second Quarter</b>	<b>First Quarter</b>
<i>(in thousands)</i>								
Net interest income (GAAP)	\$ 5,325	5,259	5,312	5,001	4,509	4,845	5,057	4,814
Tax-equivalent adjustment	396	416	416	414	415	429	440	435
Net interest income (Tax-equivalent) \$	5,721	5,675	5,728	5,415	4,924	5,274	5,497	5,249

	<b>Year ended December 31</b>				
	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
<i>(In thousands)</i>					
Net interest income (GAAP)	\$ 20,897	19,225	18,899	18,815	17,870
Tax-equivalent adjustment	1,642	1,719	1,765	1,633	1,361
Net interest income (Tax-equivalent) \$	22,539	20,944	20,664	20,448	19,231

**Table 2 - Selected Financial Data**

	Year ended December 31				
(Dollars in thousands, except per share amounts)	2012	2011	2010	2009	2008
<b>Income statement</b>					
Tax-equivalent interest income (a)	\$ 30,709	32,425	35,237	38,467	39,722
Total interest expense	8,170	11,481	14,573	18,019	20,491
Tax equivalent net interest income (a)	22,539	20,944	20,664	20,448	19,231
Provision for loan losses	3,815	2,450	3,580	5,250	870
Total noninterest income	10,483	5,177	6,718	2,433	3,900
Total noninterest expense	19,383	16,357	15,893	13,934	12,240
Net earnings before income taxes and tax-equivalent adjustment	9,824	7,314	7,909	3,697	10,021
Tax-equivalent adjustment	1,642	1,719	1,765	1,633	1,361
Income tax expense (benefit)	1,419	57	798	(340)	2,023
Net earnings	\$ 6,763	5,538	5,346	2,404	6,637
<b>Per share data:</b>					
Basic and diluted net earnings	\$ 1.86	1.52	1.47	0.66	1.81
Cash dividends declared	\$ 0.82	0.80	0.78	0.76	0.74
Weighted average shares outstanding					
Basic and diluted	3,642,831	3,642,735	3,642,851	3,644,691	3,674,384
Shares outstanding	3,642,903	3,642,738	3,642,718	3,643,117	3,646,947
Book value	\$ 19.26	17.96	15.47	15.42	15.66
Common stock price					
High	\$ 26.65	20.37	22.00	30.00	25.00
Low	18.23	18.52	16.86	18.07	19.00
Period-end	\$ 20.85	18.52	20.06	19.69	20.10
To earnings ratio	11.21 x	12.10	13.74	29.39	11.10
To book value	108 %	103	130	128	128
<b>Performance ratios:</b>					
Return on average equity	9.85 %	9.10	9.00	4.23	12.18
Return on average assets	0.90 %	0.72	0.68	0.31	0.92
Dividend payout ratio	44.09 %	52.63	53.06	115.15	40.88
Average equity to average assets	9.09 %	7.89	7.61	7.21	7.59
<b>Asset Quality:</b>					
Allowance for loan losses as a % of:					
Loans	1.69 %	1.87	2.05	1.73	1.19
Nonperforming loans	64 %	67	65	69	99
Nonperforming assets as a % of:					
Loans and foreclosed properties	3.83 %	4.83	5.22	4.34	1.29
Total assets	2.03 %	2.35	2.61	2.15	0.64
Nonperforming loans as % of loans	2.65 %	2.80	3.16	2.49	1.20
Net charge-offs as a % of average loans	1.03 %	0.86	0.64	0.84	0.17
<b>Capital Adequacy:</b>					
Tier 1 risk-based capital ratio	16.20 %	15.40	14.57	13.73	14.23
Total risk-based capital ratio	17.46 %	16.66	15.82	14.98	15.22
Tier 1 Leverage ratio	9.58 %	8.82	8.47	8.13	8.75
<b>Other financial data:</b>					
Net interest margin (a)	3.21 %	2.95	2.86	2.78	2.86
Effective income tax expense (benefit) rate	17.34 %	1.02	12.99	(16.47)	23.36
Efficiency ratio (b)	58.70 %	62.62	58.04	60.90	52.92
<b>Selected period end balances:</b>					
Securities	\$ 259,475	299,582	315,220	334,762	302,656
Loans, net of unearned income	398,193	370,263	374,215	376,103	369,162
Allowance for loan losses	6,723	6,919	7,676	6,495	4,398
Total assets	759,833	776,218	763,829	773,382	745,970
Total deposits	636,817	619,552	607,127	579,409	550,843
Long-term debt	47,217	85,313	93,331	118,349	123,368
Total stockholders' equity	70,149	65,416	56,368	56,183	57,128

(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 3 - Selected Quarterly Financial Data

		2012				2011			
(Dollars in thousands, except per share amounts)		Fourth	Third	Second	First	Fourth	Third	Second	First
Income statement									
Tax-equivalent interest income (a)	\$	7,646	7,628	7,773	7,662	7,629	8,089	8,438	8,269
Total interest expense		1,925	1,953	2,045	2,247	2,705	2,815	2,941	3,020
Tax equivalent net interest income (a)		5,721	5,675	5,728	5,415	4,924	5,274	5,497	5,249
Provision for loan losses		1,065	1,550	600	600	650	600	600	600
Total noninterest income		1,788	2,017	1,814	4,864	1,461	1,327	1,300	1,089
Total noninterest expense		4,023	3,770	4,048	7,542	4,187	4,268	4,308	3,594
Net earnings before income taxes and tax-equivalent adjustment		2,421	2,372	2,894	2,137	1,548	1,733	1,889	2,144
Tax-equivalent adjustment		396	416	416	414	415	429	440	435
Income tax expense (benefit)		365	347	449	258	(32)	(63)	(8)	160
Net earnings	\$	1,660	1,609	2,029	1,465	1,165	1,367	1,457	1,549
Per share data:									
Basic and diluted net earnings	\$	0.46	0.44	0.56	0.40	0.32	0.38	0.40	0.43
Cash dividends declared	\$	0.205	0.205	0.205	0.205	0.20	0.20	0.20	0.20
Weighted average shares outstanding									
Basic and diluted		3,642,903	3,642,876	3,642,826	3,642,738	3,642,738	3,642,738	3,642,738	3,642,728
Shares outstanding, at period end		3,642,903	3,642,903	3,642,843	3,642,738	3,642,738	3,642,738	3,642,738	3,642,738
Book value	\$	19.26	19.27	18.75	18.11	17.96	17.69	16.77	15.87
Common stock price									
High	\$	24.87	23.20	26.65	21.99	19.65	19.70	19.91	20.37
Low		20.85	21.00	21.50	18.23	18.52	19.10	19.40	19.51
Period-end	\$	20.85	22.25	21.50	21.99	18.52	19.65	19.75	19.56
To earnings ratio		11.21 x	12.94	12.95	14.66	12.10	13.55	14.01	13.49
To book value		108 %	115	115	121	103	111	118	123
Performance ratios:									
Return on average equity		9.30 %	9.22	12.06	8.86	7.15	8.81	9.90	10.84
Return on average assets		0.88 %	0.86	1.07	0.77	0.61	0.72	0.75	0.80
Dividend payout ratio		44.57 %	46.59	36.61	51.25	62.50	52.63	50.00	46.51
Average equity to average assets		9.45 %	9.33	8.85	8.74	8.50	8.12	7.58	7.36
Asset Quality:									
Allowance for loan losses as a % of:									
Loans		1.69 %	1.52	1.63	1.97	1.87	1.69	2.07	2.13
Nonperforming loans		64 %	44	79	73	67	60	95	70
Nonperforming assets as a % of :									
Loans and foreclosed properties		3.83 %	4.61	3.31	4.53	4.83	4.78	4.57	5.20
Total assets		2.03 %	2.46	1.75	2.31	2.35	2.39	2.25	2.51
Nonperforming loans as % of loans		2.65 %	3.43	2.06	2.69	2.80	2.80	2.18	3.03
Net charge-offs as % of average loans		0.39 %	2.00	1.61	0.02	0.08	2.14	0.76	0.45
Capital Adequacy:									
Tier 1 risk-based capital ratio		16.20 %	15.75	15.39	15.69	15.40	15.25	14.95	14.84
Total risk-based capital ratio		17.46 %	17.00	16.65	16.95	16.66	16.51	16.20	16.09
Tier 1 Leverage ratio		9.58 %	9.54	9.26	9.06	8.82	8.87	8.65	8.56
Other financial data:									
Net interest margin (a)		3.22 %	3.23	3.26	3.11	2.77	2.98	3.09	2.98
Effective income tax rate		18.02 %	17.74	18.12	14.97	NM	NM	NM	9.36
Efficiency ratio (b)		53.58 %	49.01	53.67	73.37	65.58	64.66	63.38	56.71
Selected period end balances:									
Securities	\$	259,475	254,819	277,246	299,902	299,582	283,070	296,443	321,098
Loans, net of unearned income		398,193	397,738	399,370	380,377	370,263	374,788	373,795	368,909
Allowance for loan losses		6,723	6,045	6,503	7,496	6,919	6,340	7,746	7,855
Total assets		759,833	753,467	766,161	760,522	776,218	764,637	779,725	781,557
Total deposits		636,817	629,824	644,246	641,195	619,552	609,070	627,969	631,394
Long-term debt		47,217	47,217	47,217	47,308	85,313	85,317	85,322	85,327
Total stockholders' equity		70,149	70,206	68,292	65,972	65,416	64,422	61,100	57,801

(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**

	Year ended December 31								
	2012			2011			2010		
	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)	\$ 395,938	\$ 21,943	5.54%	\$ 376,000	\$ 21,306	5.67%	\$ 380,552	\$ 21,809	5.73%
Securities - taxable	199,794	3,883	1.94%	223,638	6,006	2.69%	246,610	8,208	3.33%
Securities - tax-exempt (2)	77,447	4,829	6.24%	79,329	5,056	6.37%	81,256	5,190	6.39%
Total securities	277,241	8,712	3.14%	302,967	11,062	3.65%	327,866	13,398	4.09%
Federal funds sold	27,466	54	0.20%	28,905	56	0.19%	13,984	29	0.21%
Interest bearing bank deposits	793	—	—	1,394	1	0.05%	1,076	1	0.09%
Total interest-earning assets	701,438	30,709	4.38%	709,266	32,425	4.57%	723,478	35,237	4.87%
Cash and due from banks	14,125			13,054			12,267		
Other assets	39,742			48,796			44,909		
Total assets	<u>\$ 755,305</u>			<u>\$ 771,116</u>			<u>\$ 780,654</u>		
<b>Interest-bearing liabilities:</b>									
Deposits:									
NOW	\$ 99,664	349	0.35%	\$ 90,565	527	0.58%	\$ 88,070	612	0.69%
Savings and money market	153,668	859	0.56%	138,428	996	0.72%	117,725	1,228	1.04%
Certificates of deposits									
less than \$100,000	108,726	1,769	1.63%	114,490	2,227	1.95%	113,912	2,758	2.42%
Certificates of deposits and									
other time deposits of									
\$100,000 or more	161,128	3,347	2.08%	181,242	4,318	2.38%	197,387	5,440	2.76%
Total interest-bearing deposits	523,186	6,324	1.21%	524,725	8,068	1.54%	517,094	10,038	1.94%
Short-term borrowings	2,970	16	0.54%	2,423	12	0.50%	3,530	23	0.65%
Long-term debt	49,115	1,830	3.73%	86,899	3,401	3.91%	112,312	4,512	4.02%
Total interest-bearing liabilities	575,271	8,170	1.42%	614,047	11,481	1.87%	632,936	14,573	2.30%
Noninterest-bearing deposits	107,948			92,764			84,837		
Other liabilities	3,410			3,463			3,467		
Stockholders' equity	68,676			60,842			59,414		
Total liabilities and									
and stockholders' equity	<u>\$ 755,305</u>			<u>\$ 771,116</u>			<u>\$ 780,654</u>		
Net interest income and margin		<u>\$ 22,539</u>	<u>3.21%</u>		<u>\$ 20,944</u>	<u>2.95%</u>		<u>\$ 20,664</u>	<u>2.86%</u>

(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, 2012 vs. 2011			Years ended December 31, 2011 vs. 2010		
	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	\$ 637	(468)	1,105	\$ (503)	(245)	(258)
Securities - taxable	(2,123)	(1,660)	(463)	(2,202)	(1,585)	(617)
Securities - tax-exempt (1)	(227)	(110)	(117)	(134)	(11)	(123)
Total securities	(2,350)	(1,770)	(580)	(2,336)	(1,596)	(740)
Federal funds sold	(2)	1	(3)	27	(2)	29
Interest bearing bank deposits	(1)	(1)	—	—	—	—
Total interest income	<u>\$ (1,716)</u>	<u>(2,238)</u>	<u>522</u>	<u>\$ (2,812)</u>	<u>(1,843)</u>	<u>(969)</u>
<b>Interest expense:</b>						
Deposits:						
NOW	\$ (178)	(210)	32	\$ (85)	(100)	15
Savings and money market	(137)	(222)	85	(232)	(381)	149
Certificates of deposits less than \$100,000	(458)	(364)	(94)	(531)	(542)	11
Certificates of deposits and other time deposits of \$100,000 or more	(971)	(553)	(418)	(1,122)	(737)	(385)
Total interest-bearing deposits	(1,744)	(1,349)	(395)	(1,970)	(1,760)	(210)
Short-term borrowings	4	1	3	(11)	(6)	(5)
Long-term debt	(1,571)	(163)	(1,408)	(1,111)	(116)	(995)
Total interest expense	<u>(3,311)</u>	<u>(1,511)</u>	<u>(1,800)</u>	<u>(3,092)</u>	<u>(1,882)</u>	<u>(1,210)</u>
Net interest income	<u>\$ 1,595</u>	<u>(727)</u>	<u>2,322</u>	<u>\$ 280</u>	<u>39</u>	<u>241</u>

(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**

	<b>December 31</b>				
<i>(In thousands)</i>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
Commercial and industrial	\$ 59,334	54,988	53,288	53,884	53,883
Construction and land development	37,631	39,814	47,850	56,820	67,420
Commercial real estate	183,611	162,435	166,241	156,928	132,818
Residential real estate	105,631	101,725	96,241	97,407	102,835
Consumer installment	12,219	11,454	10,676	11,236	12,463
Total loans	398,426	370,416	374,296	376,275	369,419
Less: unearned income	(233)	(153)	(81)	(172)	(257)
Loans, net of unearned income	398,193	370,263	374,215	376,103	369,162
Less: allowance for loan losses	(6,723)	(6,919)	(7,676)	(6,495)	(4,398)
Loans, net	\$ 391,470	363,344	366,539	369,608	364,764

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

		December 31, 2012						
		1 year	1 to 5	After 5		Adjustable	Fixed	
<i>(Dollars in thousands)</i>		or less	years	years	Total	Rate	Rate	Total
Commercial and industrial	\$	141	53,788	5,405	59,334	36,381	22,953	59,334
Construction and land development		1,919	32,670	3,042	37,631	22,749	14,882	37,631
Commercial real estate		501	117,185	65,925	183,611	33,262	150,349	183,611
Residential real estate		820	33,617	71,194	105,631	55,919	49,712	105,631
Consumer installment		180	9,852	2,187	12,219	2,041	10,178	12,219
Total loans	\$	3,561	247,112	147,753	398,426	150,352	248,074	398,426

**Table 8 - Allowance for Loan Losses and Nonperforming Assets**

	Year ended December 31				
(Dollars in thousands)	2012	2011	2010	2009	2008
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 6,919	7,676	6,495	4,398	4,105
Charge-offs:					
Commercial and industrial	(289)	(679)	(537)	(495)	(454)
Construction and land development	(231)	(1,758)	(1,487)	(2,088)	—
Commercial real estate	(3,184)	(422)	—	—	—
Residential real estate	(545)	(533)	(552)	(704)	(153)
Consumer installment	(85)	(21)	(111)	(61)	(98)
Total charge-offs	(4,334)	(3,413)	(2,687)	(3,348)	(705)
Recoveries:					
Commercial and industrial	54	34	63	47	102
Construction and land development	46	2	54	50	—
Commercial real estate	71	—	—	—	—
Residential real estate	134	155	151	92	6
Consumer installment	18	15	20	6	20
Total recoveries	323	206	288	195	128
Net charge-offs	(4,011)	(3,207)	(2,399)	(3,153)	(577)
Provision for loan losses	3,815	2,450	3,580	5,250	870
Ending balance	\$ 6,723	6,919	7,676	6,495	4,398
as a % of loans	1.69 %	1.87	2.05	1.73	1.19
as a % of nonperforming loans	64 %	67	65	69	99
Net charge-offs as a % of average loans	1.03 %	0.86	0.64	0.84	0.17
<b>Nonperforming assets:</b>					
Nonaccrual/nonperforming loans	\$ 10,535	10,354	11,833	9,352	4,431
Other real estate owned	4,919	7,898	8,125	7,292	324
Total nonperforming assets	\$ 15,454	18,252	19,958	16,644	4,755
as a % of loans and foreclosed properties	3.83 %	4.83	5.22	4.34	1.29
as a % total assets	2.03 %	2.35	2.61	2.15	0.64
Nonperforming loans as a % of total loans	2.65 %	2.80	3.16	2.49	1.20
Accruing loans 90 days or more past due	\$ 58	—	—	5	104

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

	December 31									
	2012		2011		2010		2009		2008	
	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
<i>(Dollars in thousands)</i>										
Commercial and industrial	\$ 812	14.9	\$ 948	14.8	\$ 972	14.2	\$ 784	14.3	\$ 417	14.6
Construction and land development	1,545	9.4	1,470	10.7	2,223	12.8	2,063	15.1	873	18.3
Commercial real estate	3,137	46.1	3,009	43.9	2,893	44.4	1,264	41.7	1,175	36.0
Residential real estate	1,126	26.5	1,363	27.5	1,336	25.7	1,706	25.9	1,430	27.8
Consumer installment	103	3.1	129	3.1	141	2.9	227	3.0	166	3.4
Unallocated	—		—		111		451		337	
Total allowance for loan losses	\$ 6,723		\$ 6,919		\$ 7,676		\$ 6,495		\$ 4,398	

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

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**Table 10 - CDs and Other Time Deposits of \$100,000 or More***(Dollars in thousands)***December 31, 2012****Maturity of:**

3 months or less	\$	19,399
Over 3 months through 6 months		14,463
Over 6 months through 12 months		43,386
Over 12 months		79,576
Total CDs and other time deposits of \$100,000 or more (1)		\$ 156,824

(1) 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, 2012 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, 2012.

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, 2012 and 2011, and the related consolidated statements of earnings, comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2012. 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, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012 in conformity with U.S. generally accepted accounting principles.

KPMG LLP

Birmingham, Alabama  
March 22, 2013

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

	<b>December 31</b>	
	<b>2012</b>	<b>2011</b>
<i>(Dollars in thousands, except share data)</i>		
<b>Assets:</b>		
Cash and due from banks	\$ 18,762	\$ 12,395
Federal funds sold	42,682	41,840
Interest bearing bank deposits	505	1,193
Cash and cash equivalents	61,949	55,428
Securities available-for-sale	259,475	299,582
Loans held for sale	2,887	3,346
Loans, net of unearned income	398,193	370,263
Allowance for loan losses	(6,723)	(6,919)
Loans, net	391,470	363,344
Premises and equipment, net	10,528	9,345
Bank-owned life insurance	17,076	16,631
Other real estate owned	4,919	7,898
Other assets	11,529	20,644
Total assets	\$ 759,833	\$ 776,218
<b>Liabilities:</b>		
Deposits:		
Noninterest-bearing	\$ 118,014	\$ 106,276
Interest-bearing	518,803	513,276
Total deposits	636,817	619,552
Federal funds purchased and securities sold under agreements to repurchase	2,689	2,805
Long-term debt	47,217	85,313
Accrued expenses and other liabilities	2,961	3,132
Total liabilities	689,684	710,802
<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	3,756	3,753
Retained earnings	67,821	64,045
Accumulated other comprehensive income, net	5,174	4,222
Less treasury stock, at cost - 314,232 shares and 314,397 shares at December 31, 2012 and 2011, respectively	(6,641)	(6,643)
Total stockholders' equity	70,149	65,416
Total liabilities and stockholders' equity	\$ 759,833	\$ 776,218

*See accompanying notes to consolidated financial statements*

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

	Year ended December 31		
<i>(Dollars in thousands, except share and per share data)</i>	2012	2011	2010
<b>Interest income:</b>			
Loans, including fees	\$ 21,943	\$ 21,306	\$ 21,809
Securities	7,070	9,343	11,633
Federal funds sold and interest bearing bank deposits	54	57	30
Total interest income	29,067	30,706	33,472
<b>Interest expense:</b>			
Deposits	6,324	8,068	10,038
Short-term borrowings	16	12	23
Long-term debt	1,830	3,401	4,512
Total interest expense	8,170	11,481	14,573
<b>Net interest income</b>	20,897	19,225	18,899
<b>Provision for loan losses</b>	3,815	2,450	3,580
<b>Net interest income after provision for loan losses</b>	17,082	16,775	15,319
<b>Noninterest income:</b>			
Service charges on deposit accounts	1,111	1,167	1,280
Mortgage lending	3,445	1,922	2,494
Bank-owned life insurance	445	460	452
Gain on sale of affordable housing investments	3,268	—	—
Affordable housing investment losses	—	(646)	(323)
Other	1,535	1,396	1,392
Securities gains, net:			
Realized gains, net	809	1,216	3,451
Total other-than-temporary impairments	(130)	(468)	(2,238)
Non-credit portion of other-than-temporary impairments recognized in other comprehensive income	—	130	210
Total securities gains, net	679	878	1,423
Total noninterest income	10,483	5,177	6,718
<b>Noninterest expense:</b>			
Salaries and benefits	8,691	8,167	7,402
Net occupancy and equipment	1,332	1,404	1,450
Professional fees	704	735	702
FDIC and other regulatory assessments	686	792	1,092
Other real estate owned, net	323	2,007	1,378
Prepayment penalty on long-term debt	3,720	—	679
Other	3,927	3,252	3,190
Total noninterest expense	19,383	16,357	15,893
<b>Earnings before income taxes</b>	8,182	5,595	6,144
<b>Income tax expense</b>	1,419	57	798
<b>Net earnings</b>	\$ 6,763	\$ 5,538	\$ 5,346
<b>Net earnings per share:</b>			
Basic and diluted	\$ 1.86	\$ 1.52	\$ 1.47
<b>Weighted average shares outstanding:</b>			
Basic and diluted	3,642,831	3,642,735	3,642,851

*See accompanying notes to consolidated financial statements*

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

	For years ended December 31,		
<i>(Dollars in thousands)</i>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Net earnings</b>	\$ 6,763	\$ 5,538	\$ 5,346
<b>Other comprehensive income (loss), net of tax:</b>			
Unrealized net holding loss on other-than-temporarily impaired securities due to factors other than credit	—	(82)	(133)
Unrealized net holding gain (loss) on all other securities	1,379	7,059	(1,281)
Reclassification adjustment for net gain on securities recognized in net earnings	(427)	(554)	(898)
<b>Other comprehensive income (loss)</b>	<b>952</b>	<b>6,423</b>	<b>(2,312)</b>
<b>Comprehensive income</b>	<b>\$ 7,715</b>	<b>\$ 11,961</b>	<b>\$ 3,034</b>

*See accompanying notes to consolidated financial statements*

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

	<b>Common Stock</b>			<b>Additional</b>		<b>Retained</b>	<b>Accumulated</b>	<b>Treasury</b>	
	<b>Shares</b>	<b>Amount</b>		<b>paid-in</b>		<b>earnings</b>	<b>other</b>	<b>stock</b>	<b>Total</b>
<i>(Dollars in thousands, except share data)</i>				<b>capital</b>			<b>comprehensive</b>		
							<b>(loss) income</b>		
<b>Balance, December 31, 2009</b>	3,957,135	\$ 39	\$	3,751	\$	58,917	\$ 111	\$ (6,635)	\$ 56,183
Net earnings	—	—		—		5,346	—	—	5,346
Other comprehensive loss	—	—		—		—	(2,312)	—	(2,312)
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
Net earnings	—	—		—		5,538	—	—	5,538
Other comprehensive income	—	—		—		—	6,423	—	6,423
Cash dividends paid (\$0.80 per share)	—	—		—		(2,914)	—	—	(2,914)
Sale of treasury stock (20 shares)	—	—		1		—	—	—	1
<b>Balance, December 31, 2011</b>	3,957,135	\$ 39	\$	3,753	\$	64,045	\$ 4,222	\$ (6,643)	\$ 65,416
Net earnings	—	—		—		6,763	—	—	6,763
Other comprehensive income	—	—		—		—	952	—	952
Cash dividends paid (\$0.82 per share)	—	—		—		(2,987)	—	—	(2,987)
Sale of treasury stock (165 shares)	—	—		3		—	—	2	5
<b>Balance, December 31, 2012</b>	3,957,135	\$ 39	\$	3,756	\$	67,821	\$ 5,174	\$ (6,641)	\$ 70,149

See accompanying notes to consolidated financial statements

## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(In thousands)	Year ended December 31		
	2012	2011	2010
<b>Cash flows from operating activities:</b>			
Net earnings	\$ 6,763	\$ 5,538	\$ 5,346
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Provision for loan losses	3,815	2,450	3,580
Depreciation and amortization	837	665	579
Premium amortization and discount accretion, net	2,992	2,445	2,071
Deferred tax expense (benefit)	624	(368)	(777)
Net gain on securities available for sale	(679)	(878)	(1,423)
Net gain on sale of loans held for sale	(3,430)	(1,680)	(2,143)
Net loss on other real estate owned	245	1,830	1,217
Loss on prepayment of long-term debt	3,720	—	679
Loans originated for sale	(154,044)	(71,350)	(100,721)
Proceeds from sale of loans	156,967	73,550	102,940
Net loss on disposition of premises and equipment	—	—	4
Increase in cash surrender value of bank owned life insurance	(445)	(460)	(452)
Gain on sale of affordable housing partnership investments	(3,268)	—	—
Loss on affordable housing partnership investments	—	646	323
Net decrease in other assets	1,131	1,015	1,694
Net (decrease) increase in accrued expenses and other liabilities	(171)	685	(1,034)
Net cash provided by operating activities	\$ 15,057	\$ 14,088	\$ 11,883
<b>Cash flows from investing activities:</b>			
Proceeds from sales of securities available-for-sale	57,650	128,715	180,206
Proceeds from maturities of securities available-for-sale	112,005	95,641	194,570
Purchase of securities available-for-sale	(130,352)	(200,106)	(359,547)
Increase in loans, net	(33,456)	(2,824)	(3,221)
Net purchases of premises and equipment	(1,549)	(1,568)	(146)
Decrease in FHLB stock	2,067	856	227
Capital contributions to affordable housing limited partnerships	—	(4,378)	(1,500)
Proceeds from sale of affordable housing limited partnerships	8,499	—	—
Proceeds from sale of other real estate owned	4,249	1,966	660
Net cash provided by investing activities	\$ 19,113	\$ 18,302	\$ 11,249
<b>Cash flows from financing activities:</b>			
Net increase in noninterest-bearing deposits	11,738	18,616	11,163
Net increase (decrease) in interest-bearing deposits	5,527	(6,191)	16,555
Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase	(116)	120	(13,275)
Repayments or retirement of long-term debt	(41,816)	(8,018)	(25,697)
Proceeds from sale of treasury stock	5	1	2
Stock repurchases	—	—	(9)
Dividends paid	(2,987)	(2,914)	(2,842)
Net cash (used in) provided by financing activities	\$ (27,649)	\$ 1,614	\$ (14,103)
Net change in cash and cash equivalents	\$ 6,521	\$ 34,004	\$ 9,029
Cash and cash equivalents at beginning of period	55,428	21,424	12,395
<b>Cash and cash equivalents at end of period</b>	<b>\$ 61,949</b>	<b>\$ 55,428</b>	<b>\$ 21,424</b>
<b>Supplemental disclosures of cash flow information:</b>			
Cash paid during the period for:			
Interest	\$ 11,846	\$ 11,713	\$ 15,044
Income taxes	1,224	347	2,133
<b>Supplemental disclosure of non-cash transactions:</b>			
Real estate acquired through foreclosure	\$ 1,515	\$ 3,569	\$ 2,710
<i>See accompanying notes to consolidated financial statements</i>			



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## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

### 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 subsidiaries. Auburn National Bancorporation Capital Trust I is an affiliate of the Company and was included in these consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts 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.

##### Accounting Standards adopted in 2012

In the first quarter of 2012, the Company adopted new guidance related to the following Codification topics:

- ASU 2011-03, *Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements*;
- ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*;
- ASU 2011-05, *Comprehensive Income: Presentation of Comprehensive Income*; and
- ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*.

Information about these pronouncements is described in more detail below.

ASU 2011-03, *Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements*, removes from the assessment of effective control the criterion relating to the transferor’s ability to repurchase or redeem financial assets on substantially the agreed-upon terms, even if the transferee were to default. The requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement assets is also eliminated. The amendments in this ASU were effective for interim and annual periods beginning after December 31, 2011, with prospective application to transactions or modifications of existing transactions that occur on or after the effective date. Adoption of this ASU did not have a significant impact on the financial statements of the Company.

ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, outlines the collaborative effort of the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) to consistently define fair value and to come up with a set of consistent disclosures for fair value. The ASU changes certain fair value measurement principles and enhances the disclosure requirements particularly for level 3 fair value measurements. This update was effective for the Company in the first quarter of 2012 and will be applied prospectively. Adoption of the ASU required expanded disclosure of the Company’s fair value disclosures. See Note 17, Fair Value.

ASU 2011-05, *Comprehensive Income: Presentation of Comprehensive Income*, amends existing standards allowing either a single continuous statement of comprehensive income or two separate but consecutive statements of income and comprehensive income. An entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income in both options. This update also requires companies to present amounts reclassified out of other comprehensive income and into net income on the face of the statement of income. In December 2011, the FASB issued ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, which defers indefinitely the requirement to present reclassification adjustments on the statement of income. The remaining provisions were effective for the Company in the first quarter of 2012 with retrospective application. This Update did not affect our consolidated financial results as it amends only the presentation of comprehensive income. See Consolidated Statements of Comprehensive Income.

### **Cash Equivalents**

Cash equivalents include cash on hand, cash items in process of collection, amounts due from banks, including interest bearing deposits with other banks, and federal funds sold.

### **Securities**

Securities are classified based on management's intention at the date of purchase. At December 31, 2012, 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 recognized in interest income over the anticipated life of the security using the effective interest method, 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), 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 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 in the aggregate. 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 Bank's mortgage lending activities of originating mortgage loans and selling those loans in the secondary market, the Bank makes various representations and warranties to the purchaser of the mortgage loans. Every loan closed by the Bank's mortgage center is run through a government agency automated underwriting

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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. 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. In 2012, we repurchased one residential mortgage loan with an unpaid principal balance of \$0.3 million. This loan was current as to principal and interest at the time of repurchase, and we incurred no losses upon repurchase. Except for this loan, during 2012, 2011 and 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 in interest income over the contractual life of the loan using the effective 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 is 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 may grant concessions to borrowers who 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 restructuring 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 restructuring. 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 noninterest expense along with holding costs.

**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 Bank's common stock and surplus (with regard to the relationship with the Federal Reserve Bank) or outstanding borrowings (with regard to the relationship with the Federal Home Loan Bank of Atlanta). 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.

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## **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 in the accompanying 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. 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 subsidiaries 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 17, Fair Value.

## **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, 2012. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

**NOTE 2: BASIC AND DILUTED EARNINGS PER SHARE**

Basic net earnings per share is 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, 2012, 2011, and 2010, the Company had no options or other equity awards 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, 2012, 2011 and 2010, respectively, is presented below.

<i>(Dollars in thousands, except share and per share data)</i>	<b>Year ended December 31</b>		
	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Basic and diluted:</b>			
Net earnings	\$ 6,763	\$ 5,538	\$ 5,346
Weighted average common shares outstanding	3,642,831	3,642,735	3,642,851
Earnings per share	\$ 1.86	\$ 1.52	\$ 1.47

**NOTE 3: VARIABLE INTEREST ENTITIES**

Generally, a variable interest entity ("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, 2012, the Company did not have any consolidated VIEs to disclose but did have one nonconsolidated VIE, 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 included in interest expense on long-term debt. For regulatory reporting and capital adequacy purposes, the Federal Reserve Board has proposed, as part of its Basel III capital rules, to phase out trust preferred securities as Tier 1 Capital over 10 years for institutions with total assets under \$15 billion.

The following table summarizes VIEs that are not consolidated by the Company as of December 31, 2012.

<i>(Dollars in thousands)</i>	<b>Maximum</b>	<b>Liability</b>	<b>Classification</b>
	<b>Loss Exposure</b>	<b>Recognized</b>	
<b>Type:</b>			
Trust preferred issuances	N/A	\$ 7,217	Long-term debt

**NOTE 4: 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. As of December 31, 2012 and 2011, the Bank did not have a required reserve balance at the Federal Reserve Bank.

## NOTE 5: SECURITIES

At December 31, 2012 and 2011, 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, 2012 and 2011, respectively, are presented below.

		1 year	1 to 5	5 to 10	After 10	Fair	Gross Unrealized		Amortized
(Dollars in thousands)		or less	years	years	years	Value	Gains	Losses	Cost
<b>December 31, 2012</b>									
Agency obligations (a)	\$	—	—	20,065	19,460	39,525	187	19	\$ 39,357
Agency RMBS (a)		—	—	4,700	136,760	141,460	3,012	162	138,610
State and political subdivisions		111	1,830	21,006	54,891	77,838	5,222	—	72,616
Trust preferred securities		—	—	—	652	652	113	154	693
Total available-for-sale	\$	111	1,830	45,771	211,763	259,475	8,534	335	\$ 251,276
<b>December 31, 2011</b>									
Agency obligations (a)	\$	—	—	5,013	46,072	51,085	182	1	\$ 50,904
Agency RMBS (a)		—	—	14,935	149,863	164,798	2,534	129	162,393
State and political subdivisions		—	414	17,761	63,538	81,713	4,339	48	77,422
Trust preferred securities		—	—	—	1,986	1,986	186	373	2,173
Total available-for-sale	\$	—	414	37,709	261,459	299,582	7,241	551	\$ 292,892

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

Securities with aggregate fair values of \$134.0 million and \$161.5 million at December 31, 2012 and 2011, 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 on the Consolidated Balance Sheets are cost-method investments. The carrying amounts of cost-method investments were \$3.0 and \$5.0 million at December 31, 2012 and 2011, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (“FRB”) stock.

### Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at December 31, 2012 and 2011, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or more are presented below.

	Less than 12 Months		12 Months or Longer		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
(Dollars in thousands)	Value	Losses	Value	Losses	Value	Losses
<b>December 31, 2012:</b>						
Agency obligations	\$ 9,966	19	—	—	9,966	\$ 19
Agency RMBS	25,207	162	—	—	25,207	162
Trust preferred securities	—	—	346	154	346	154
Total	\$ 35,173	181	346	154	35,519	\$ 335
<b>December 31, 2011:</b>						
Agency obligations	\$ 5,000	1	—	—	5,000	\$ 1
Agency RMBS	17,020	129	—	—	17,020	129
State and political subdivisions	1,686	11	718	37	2,404	48
Trust preferred securities	—	—	857	373	857	373
Total	\$ 23,706	141	1,575	410	25,281	\$ 551

For the securities in the previous table, the Company does not have the intent to sell and has determined 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 assesses 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.

### *Agency obligations*

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

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

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

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

The unrealized losses associated with securities of U.S. states and political subdivisions were primarily driven by changes in interest rates and were not due to the credit quality of the securities. Some of these securities are guaranteed by a bond insurer, but management did not rely on the guarantee in making its investment decision. 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.

### *Trust preferred securities*

The unrealized losses associated with individual issuer trust preferred securities were related to securities issued on behalf of individual community bank holding companies. Management evaluates the financial performance of individual community bank holding companies on a quarterly basis to determine if it is probable that such 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, 2012, cost-method investments with an aggregate cost of \$3.0 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 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 trust preferred securities at December 31, 2012 and 2011, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer.

#### Trust Preferred Securities as of December 31, 2012

	<u>Credit Rating</u>		<u>Fair</u>	<u>Unrealized Losses</u>			<u>Life-to-date</u>

n/a - not applicable securities not rated.

(a) 144A Floating Rate Capital Securities. Underlying issuer is a community bank holding company. Securities have no excess subordination or overcollateralization.

#### Trust Preferred Securities as of December 31, 2011

	Credit Rating		Fair Value	Unrealized Losses			Life-to-date Impairment Charges
	Moody's	Fitch		Less than 12 months	12 months or Longer	Total	
<i>(Dollars in thousands)</i>							
<b>Pooled:</b>							
ALESCO Preferred Funding XVII Ltd (a)	C	CC	\$ 100	—	130	130	\$ 1,770
<b>Individual issuer (b):</b>							
Carolina Financial Capital Trust I	n/a	n/a	193	—	—	—	257
Main Street Bank Statutory Trust I (c)	n/a	n/a	389	—	111	111	—
MNB Capital Trust I	n/a	n/a	55	—	—	—	445
PrimeSouth Capital Trust I	n/a	n/a	75	—	—	—	425
TCB Trust	n/a	n/a	368	—	132	132	—
United Community Capital Trust	n/a	n/a	806	—	—	—	379
Total individual issuer			1,886	—	243	243	1,506
Total trust preferred securities			\$ 1,986	—	373	373	\$ 3,276

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.

#### Other-Than-Temporarily Impaired Securities

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 2012, 2011, and 2010, for credit-impaired debt securities are presented as additions in two components based upon whether the current period 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 the security is fully written-down and deemed worthless. Changes in the credit loss component of credit-impaired debt securities were:

(Dollars in thousands)	Year ended December 31		
	2012	2011	2010
Balance, beginning of period	\$ 3,276	2,938	4,570
Additions:			
Initial credit impairments	—	—	1,160
Subsequent credit impairments	130	338	58
Reductions:			
Securities sold	(2,149)	—	(975)
Securities fully written down and deemed worthless	—	—	(1,875)
Balance, end of period	\$ 1,257	3,276	2,938

### Other-Than-Temporary Impairment

The following table presents details of the other-than-temporary impairment related to securities.

(Dollars in thousands)	Year ended December 31		
	2012	2011	2010
<b>Other-than-temporary impairment charges (included in earnings):</b>			
Debt securities:			
Corporate debt securities	\$ —	—	810
Pooled trust preferred securities	—	—	50
Individual issuer trust preferred securities	130	338	1,168
Total debt securities	\$ 130	338	2,028
Total other-than-temporary impairment charges (included in earnings)	\$ 130	338	2,028
<b>Other-than-temporary impairment on debt securities:</b>			
Recorded as part of gross realized losses:			
Credit-related	130	338	1,218
Securities with intent to sell	—	—	810
Recorded directly to other comprehensive income for non-credit related impairment	—	130	210
Total other-than-temporary impairment on debt securities	\$ 130	468	2,238

### Realized Gains and Losses

The following table presents the gross realized gains and losses on sales and other-than-temporary impairment charges related to securities.

(Dollars in thousands)	Year ended December 31		
	2012	2011	2010
Gross realized gains	\$ 1,005	1,698	3,496
Gross realized losses	(196)	(482)	(45)
Other-than-temporary impairment charges	(130)	(338)	(2,028)
Realized gains, net	\$ 679	878	1,423

**NOTE 6: LOANS AND ALLOWANCE FOR LOAN LOSSES**

(In thousands)	December 31	
	2012	2011
Commercial and industrial	\$ 59,334	\$ 54,988
Construction and land development	37,631	39,814
Commercial real estate:		
Owner occupied	64,368	70,202
Other	119,243	92,233
Total commercial real estate	183,611	162,435
Residential real estate:		
Consumer mortgage	58,087	57,958
Investment property	47,544	43,767
Total residential real estate	105,631	101,725
Consumer installment	12,219	11,454
Total loans	398,426	370,416
Less: unearned income	(233)	(153)
Loans, net of unearned income	\$ 398,193	\$ 370,263

Loans secured by real estate were approximately 82.0% of the total loan portfolio at December 31, 2012. 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, 2012, 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. As part of the Company's quarterly assessment of the allowance, the 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. 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 includes first 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, 2012 and 2011.

<i>(In thousands)</i>	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non- Accrual	Total Loans
<b>December 31, 2012:</b>						
Commercial and industrial	\$ 59,101	173	—	59,274	60	\$ 59,334
Construction and land development	35,917	8	—	35,925	1,706	37,631
Commercial real estate:						
Owner occupied	63,323	—	—	63,323	1,045	64,368
Other	113,344	230	—	113,574	5,669	119,243
Total commercial real estate	176,667	230	—	176,897	6,714	183,611
Residential real estate:						
Consumer mortgage	55,521	1,202	58	56,781	1,306	58,087
Investment property	46,460	335	—	46,795	749	47,544
Total residential real estate	101,981	1,537	58	103,576	2,055	105,631
Consumer installment	12,157	62	—	12,219	—	12,219
Total	\$ 385,823	2,010	58	387,891	10,535	\$ 398,426
<b>December 31, 2011:</b>						
Commercial and industrial	\$ 53,721	1,191	—	54,912	76	\$ 54,988
Construction and land development	34,402	317	—	34,719	5,095	39,814
Commercial real estate:						
Owner occupied	68,551	—	—	68,551	1,651	70,202
Other	90,427	—	—	90,427	1,806	92,233
Total commercial real estate	158,978	—	—	158,978	3,457	162,435
Residential real estate:						
Consumer mortgage	56,610	400	—	57,010	948	57,958
Investment property	42,144	845	—	42,989	778	43,767
Total residential real estate	98,754	1,245	—	99,999	1,726	101,725
Consumer installment	11,397	57	—	11,454	—	11,454
Total	\$ 357,252	2,810	—	360,062	10,354	\$ 370,416

The gross interest income which would have been recorded under the original terms of those nonaccrual loans had they been accruing interest, amounted to approximately \$511 thousand, \$494 thousand and \$346 thousand for the years ended December 31, 2012, 2011, and 2010, respectively.

### Allowance for Loan Losses

The allowance for loan losses as of and for the years ended December 31, 2012, 2011 and 2010, is presented below.

(In thousands)	Year ended December 31		
	2012	2011	2010
Beginning balance	\$ 6,919	\$ 7,676	\$ 6,495
Charged-off loans	(4,334)	(3,413)	(2,687)
Recovery of previously charged-off loans	323	206	288
Net charge-offs	(4,011)	(3,207)	(2,399)
Provision for loan losses	3,815	2,450	3,580
Ending balance	\$ 6,723	\$ 6,919	\$ 7,676

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 portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a 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 loss rates 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. Loans are charged off, in whole or in part, 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.

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. 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 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 internal and independent loan review processes. 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 it 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, construction and land development, 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, 2012 and 2011, and for the years then ended, 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 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 regularly re-evaluates its practices in determining the allowance for loan losses. During the fourth quarter of 2011, the Company's management decided to eliminate a previously unallocated component of the allowance. As a result, the Company had no unallocated amount included in the allowance at December 31, 2012 and 2011.

The following table details the changes in the allowance for loan losses by portfolio segment for the years ended December 31, 2012 and 2011.

<i>(in thousands)</i>	<b>Commercial and industrial</b>	<b>Construction and land Development</b>	<b>Commercial Real Estate</b>	<b>Residential Real Estate</b>	<b>Consumer Installment</b>	<b>Unallocated</b>	<b>Total</b>
<b>Balance, December 31, 2010</b>	\$ 972	2,223	2,893	1,336	141	111	\$ 7,676
Charge-offs	(679)	(1,758)	(422)	(533)	(21)	—	(3,413)
Recoveries	34	2	—	155	15	—	206
Net charge-offs	(645)	(1,756)	(422)	(378)	(6)	—	(3,207)
Provision	621	1,003	538	405	(6)	(111)	2,450
<b>Balance, December 31, 2011</b>	\$ 948	1,470	3,009	1,363	129	—	\$ 6,919
Charge-offs	(289)	(231)	(3,184)	(545)	(85)	—	(4,334)
Recoveries	54	46	71	134	18	—	323
Net charge-offs	(235)	(185)	(3,113)	(411)	(67)	—	(4,011)
Provision	99	260	3,241	174	41	—	3,815
<b>Balance, December 31, 2012</b>	\$ 812	1,545	3,137	1,126	103	—	\$ 6,723

The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of December 31, 2012 and 2011.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
<i>(In thousands)</i>						
<b>December 31, 2012:</b>						
Commercial and industrial	\$ 812	59,165	—	169	812	59,334
Construction and land development	1,417	36,008	129	1,623	1,545	37,631
Commercial real estate	3,002	176,085	134	7,526	3,137	183,611
Residential real estate	1,126	104,414	—	1,217	1,126	105,631
Consumer installment	103	12,219	—	—	103	12,219
Total	\$ 6,460	387,891	263	10,535	6,723	398,426
<b>December 31, 2011:</b>						
Commercial and industrial	\$ 948	54,772	—	216	948	54,988
Construction and land development	1,323	34,719	147	5,095	1,470	39,814
Commercial real estate	2,201	158,053	808	4,382	3,009	162,435
Residential real estate	1,097	100,432	266	1,293	1,363	101,725
Consumer installment	129	11,454	—	—	129	11,454
Total	\$ 5,698	359,430	1,221	10,986	6,919	370,416

(1) Represents loans collectively evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies* (formerly FAS 5), and pursuant to amendments by ASU 2010-20 regarding allowance for unimpaired loans

(2) Represents loans individually evaluated for impairment in accordance with ASC 310-30, *Receivables* (formerly FAS 114), and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

**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.
- Substandard Accruing – 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.

<i>(In thousands)</i>	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
<b>December 31, 2012</b>					
Commercial and industrial	\$ 58,487	224	563	60	\$ 59,334
Construction and land development	34,490	310	1,125	1,706	37,631
Commercial real estate:					
Owner occupied	59,270	2,528	1,525	1,045	64,368
Other	111,719	653	1,202	5,669	119,243
Total commercial real estate	170,989	3,181	2,727	6,714	183,611
Residential real estate:					
Consumer mortgage	49,462	1,544	5,775	1,306	58,087
Investment property	43,559	1,033	2,203	749	47,544
Total residential real estate	93,021	2,577	7,978	2,055	105,631
Consumer installment	11,850	155	214	—	12,219
Total	\$ 368,837	6,447	12,607	10,535	\$ 398,426
<b>December 31, 2011</b>					
Commercial and industrial	\$ 52,834	1,359	719	76	\$ 54,988
Construction and land development	33,373	266	1,080	5,095	39,814
Commercial real estate:					
Owner occupied	62,543	4,951	1,057	1,651	70,202
Other	81,584	622	8,221	1,806	92,233
Total commercial real estate	144,127	5,573	9,278	3,457	162,435
Residential real estate:					
Consumer mortgage	50,156	1,575	5,279	948	57,958
Investment property	38,732	2,225	2,032	778	43,767
Total residential real estate	88,888	3,800	7,311	1,726	101,725
Consumer installment	11,078	248	128	—	11,454
Total	\$ 330,300	11,246	18,516	10,354	\$ 370,416



## 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, 2012 and 2011.

	December 31, 2012			
	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
<i>(In thousands)</i>				
<b>With no allowance recorded:</b>				
Commercial and industrial	\$ 169	—	169	
Construction and land development	2,879	(1,682)	1,197	
Commercial real estate:				
Owner occupied	787	(212)	575	
Other	7,914	(1,862)	6,052	
Total commercial real estate	8,701	(2,074)	6,627	
Residential real estate:				
Consumer mortgages	971	(152)	819	
Investment property	508	(110)	398	
Total residential real estate	1,479	(262)	1,217	
Total	\$ 13,228	(4,018)	9,210	
<b>With allowance recorded:</b>				
Construction and land development	\$ 471	(45)	426	\$ 129
Commercial real estate:				
Owner occupied	899	—	899	134
Total commercial real estate	899	—	899	134
Total	\$ 1,370	(45)	1,325	\$ 263
<b>Total impaired loans</b>	<b>\$ 14,598</b>	<b>(4,063)</b>	<b>10,535</b>	<b>\$ 263</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.

	December 31, 2011			
	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
<i>(In thousands)</i>				
<b>With no allowance recorded:</b>				
Commercial and industrial	\$ 216	—	216	
Construction and land development	3,958	(1,572)	2,386	
Commercial real estate:				
Owner occupied	361	(11)	350	
Other	655	(50)	605	
Total commercial real estate	1,016	(61)	955	
Total	\$ 5,190	(1,633)	3,557	
<b>With allowance recorded:</b>				
Construction and land development	\$ 2,882	(173)	2,709	\$ 147
Commercial real estate:				
Owner occupied	2,255	(29)	2,226	544
Other	1,242	(41)	1,201	264
Total commercial real estate	3,497	(70)	3,427	808
Residential real estate:				
Consumer mortgages	1,707	(797)	910	103
Investment property	390	(7)	383	163
Total residential real estate	2,097	(804)	1,293	266
Total	\$ 8,476	(1,047)	7,429	\$ 1,221
<b>Total impaired loans</b>	<b>\$ 13,666</b>	<b>(2,680)</b>	<b>10,986</b>	<b>\$ 1,221</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.

The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class.

	Year ended December 31, 2012		Year ended December 31, 2011	
	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized
<i>(In thousands)</i>				
<b>Impaired loans:</b>				
Commercial and industrial	\$ 194	13	\$ 316	9
Construction and land development	3,888	—	4,136	—
Commercial real estate:				
Owner occupied	2,449	64	1,828	24
Other	2,621	—	2,374	—
Total commercial real estate	5,070	64	4,202	24
Residential real estate:				
Consumer mortgages	861	—	1,376	—
Investment property	652	—	146	—
Total residential real estate	1,513	—	1,522	—
<b>Total</b>	<b>\$ 10,665</b>	<b>77</b>	<b>\$ 10,176</b>	<b>33</b>

For the year ended December 31, 2010, the average recorded investment in impaired loans was \$9.2 million. Total interest income recognized on impaired loans for the year ended December 31, 2010 was not material.

#### Troubled Debt Restructurings

Impaired loans also include TDRs. In the normal course of business, management may grant concessions to borrowers who are experiencing financial difficulty. A concession may include, but is not limited to, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date or reduction of the face amount or maturity amount of the debt. A concession has been granted when, as a result of the restructuring, the Bank does not expect to collect all amounts due, including interest at the original stated rate. A concession may have also been granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. The Company's determination of whether a loan modification is a TDR, the Company considers the individual facts and circumstances surrounding each modification. 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 restructuring.

Similar to other impaired loans, TDRs are measured for impairment based on the present value of expected payments using the loan's original effective interest rate as the discount rate, or the fair value of the collateral, less selling costs if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, impairment is recognized by establishing a valuation allowance as part of the allowance for loan losses or a charge-off to the allowance for loan losses. In periods subsequent to the modification, all TDRs are evaluated individually, including those that have payment defaults, for possible impairment.

The following is a summary of accruing and nonaccrual TDRs and the related loan losses, by portfolio segment and class.

(In thousands)	TDRs			Related Allowance
	Accruing	Nonaccrual	Total	
<b>December 31, 2012</b>				
Commercial and industrial	\$ 169	—	169	\$ —
Construction and land development	—	1,623	1,623	129
Commercial real estate:				
Owner occupied	899	1,045	1,944	134
Other	—	432	432	—
Total commercial real estate	899	1,477	2,376	134
Residential real estate:				
Consumer mortgages	—	819	819	—
Investment property	—	188	188	—
Total residential real estate	—	1,007	1,007	—
Total	\$ 1,068	4,107	5,175	\$ 263
<b>December 31, 2011</b>				
Commercial and industrial	\$ 216	—	216	\$ —
Construction and land development	—	5,095	5,095	147
Commercial real estate:				
Owner occupied	925	1,172	2,097	420
Other	—	1,806	1,806	264
Total commercial real estate	925	2,978	3,903	684
Residential real estate:				
Investment property	—	383	383	163
Total residential real estate	—	383	383	163
Total	\$ 1,141	8,456	9,597	\$ 994

At December 31, 2012, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

The following table summarizes loans modified in a TDR during the respective periods both before and after modification.

(\$ in thousands)	Year ended December 31, 2012			Year ended December 31, 2011		
	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
<b>TDRs:</b>						
Commercial and industrial	—	\$ —	—	2	\$ 791	523
Construction and land development	4	5,419	4,305	3	4,925	4,894
Commercial real estate:						
Owner occupied	4	3,167	2,225	5	3,127	2,840
Other	2	1,803	1,657	1	1,229	1,229
Total commercial real estate	6	4,970	3,882	6	4,356	4,069
Residential real estate:						
Consumer mortgages	2	863	858	—	—	—
Investment property	2	567	563	1	391	391
Total residential real estate	4	1,430	1,421	1	391	391
Total	14	\$ 11,819	9,608	12	\$ 10,463	9,877

The majority of the loans modified in a TDR during the years ended December 31, 2012 and 2011, respectively, included delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was not considered to be a market rate.

For the year ended December 31, 2012, decreases in the post modification outstanding recorded investment were primarily due to principal payments made by borrowers at the date of modification for construction and land development loans and A/B note restructurings for two owner occupied commercial real estate loans. In certain circumstances, the Company may require the borrower to reduce the principal balance in order to grant an extension or renewal of the loan. Total charge-offs related to B notes were \$0.9 million for the year ended December 31, 2012.

For the year ended December 31, 2011, decreases in the post modification outstanding recorded investment were primarily due to two A/B note restructurings, where the B note was charged off. Total charge-offs related to B notes during the year ended 2011 were approximately \$0.6 million.

The following table summarizes the recorded investment in loans modified in a TDR within the previous twelve months for which there was a payment default (defined as 90 days or more past due) during the respective periods.

	Year ended December 31, 2012		Year ended December 31, 2011	
	Number of Contracts	Recorded investment	Number of Contracts	Recorded investment
(\$ in thousands)				
<b>TDRs:</b>				
Construction and land development	1	\$ 2,386	—	\$ —
Commercial real estate:				
Owner occupied	—	—	2	1,172
Other	—	—	1	1,201
Total commercial real estate	—	—	3	2,373
<b>Total</b>	<b>1</b>	<b>\$ 2,386</b>	<b>3</b>	<b>\$ 2,373</b>

#### NOTE 7: PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2012 and 2011 is presented below.

	December 31	
	2012	2011
(Dollars in thousands)		
Land	\$ 4,983	4,983
Buildings and improvements	9,110	7,784
Furniture, fixtures, and equipment	3,132	3,200
Total premises and equipment	17,225	15,967
Less: accumulated depreciation	(6,697)	(6,622)
<b>Premises and equipment, net</b>	<b>\$ 10,528</b>	<b>9,345</b>

Depreciation expense was approximately \$366 thousand, \$328 thousand, and \$319 thousand for the years ended December 31, 2012, 2011 and 2010, respectively, and is a component of net occupancy and equipment expense in the consolidated statements of earnings.

#### NOTE 8: MORTGAGE SERVICING RIGHTS, NET

Mortgage servicing rights ("MSRs") are recognized based on the fair value of the servicing rights on the date the corresponding mortgage loans are 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. MSRs are included in other assets on the accompanying Consolidated Balance Sheets.

The Company periodically evaluates mortgage servicing rights for impairment. 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. The valuation allowance is adjusted as the fair value changes. Changes in the valuation allowance are recognized in earnings as a component of mortgage lending income.

The change in amortized MSR's and the related valuation allowance for the years ended December 31, 2012, 2011 and 2010, is presented below.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2012	2011	2010
Beginning balance	\$ 1,245	1,189	834
Additions, net	966	415	524
Amortization expense	(416)	(242)	(169)
Change in valuation allowance	(269)	(117)	—
Ending balance	\$ 1,526	1,245	1,189

**Valuation allowance included in MSR's, net:**

Beginning of period	\$ 117	—	—
End of period	386	117	—

**Fair value of amortized MSR's:**

Beginning of period	\$ 1,245	1,335	978
End of period	1,526	1,245	1,335

Data and assumptions used in the fair value calculation related to MSR's at December 31, 2012 and 2011, respectively, are presented below.

<i>(Dollars in thousands)</i>	December 31	
	2012	2011
Unpaid principal balance	\$ 283,306	196,069
Weighted average prepayment speed (CPR)	23.7 %	17.8
Discount rate (annual percentage)	11.0 %	11.0
Weighted average coupon interest rate	3.9 %	4.4
Weighted average remaining maturity (months)	275	276
Weighted average servicing fee (basis points)	25.0	25.0

At December 31, 2012, the weighted average amortization period for MSR's was 3.3 years. Estimated amortization expense for each of the next five years is presented below.

<i>(Dollars in thousands)</i>	December 31, 2012
2013	\$ 425
2014	311
2015	226
2016	154
2017	109

## NOTE 9: DEPOSITS

At December 31, 2012, the scheduled maturities of certificates of deposit and other time deposits are presented below.

<i>(Dollars in thousands)</i>		December 31, 2012
2013		\$ 137,179
2014		55,459
2015		27,136
2016		8,728
2017		24,262
Thereafter		10,431
Total certificates of deposit and other time deposits		\$ 263,195

Additionally, at December 31, 2012 and 2011, approximately \$156.8 and \$169.2 million, respectively, of certificates of deposit and other time deposits were issued in denominations of \$100,000 or greater.

At December 31, 2012 and 2011, the amount of deposit accounts in overdraft status that were reclassified to loans on the accompanying consolidated balance sheets was not material.

## NOTE 10: SHORT-TERM BORROWINGS

At December 31, 2012, 2011, and 2010, the composition of short-term borrowings is presented below.

<i>(Dollars in thousands)</i>	2012		2011		2010	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
<b>Federal funds purchased:</b>						
As of December 31	\$ —	—	\$ —	—	\$ —	—
Average during the year	225	0.96 %	6	1.00 %	1,125	0.94 %
Maximum outstanding at any month-end	1,925		—		—	
<b>Securities sold under agreements to repurchase:</b>						
As of December 31	\$ 2,689	0.50 %	\$ 2,805	0.50 %	\$ 2,685	0.50 %
Average during the year	2,746	0.50 %	2,416	0.50 %	2,404	0.50 %
Maximum outstanding at any month-end	3,174		2,936		2,858	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling \$40.0 million with none outstanding at December 31, 2012.

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 \$8.0 million and \$4.3 million at December 31, 2012 and 2011, respectively, were pledged to secure securities sold under agreements to repurchase.

**NOTE 11: LONG-TERM DEBT**

At December 31, 2012 and 2011, the composition of long-term debt is presented below.

	2012		2011	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
<i>(Dollars in thousands)</i>				
FHLB advances, due 2014 to 2018	\$ 25,000	3.42 %	\$ 63,096	3.93 %
Securities sold under agreements to repurchase, due 2017	15,000	4.21	15,000	4.21
Subordinated debentures, due 2033	7,217	3.38	7,217	3.38
Total long-term debt	\$ 47,217	3.66 %	\$ 85,313	3.93 %

The Bank had \$25.0 million and \$63.1 million of FHLB advances with original maturities greater than one year at December 31, 2012 and 2011, respectively. Securities with an aggregate carrying value of \$1.5 million and \$33.0 million and certain qualifying residential mortgage loans with an aggregate carrying value of \$45.5 million and \$51.8 million at December 31, 2012 and 2011, respectively, were pledged to secure long-term FHLB advances.

The Bank had \$15.0 million in securities sold under agreements to repurchase with an original maturity greater than one year at December 31, 2012 and 2011. Securities with an aggregate carrying value of \$19.0 million at December 31, 2012 and 2011 were pledged to secure long-term securities sold under agreements to repurchase.

The Company formed Auburn National Bancorporation Capital Trust I, 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>	2013	2014	2015	2016	2017	Thereafter	Total
FHLB advances	\$ —	10,000	5,000	—	5,000	5,000	25,000
Securities sold under							
agreements to repurchase	—	—	—	—	15,000	—	15,000
Subordinated debentures	—	—	—	—	—	7,217	7,217
Total long-term debt	\$ —	10,000	5,000	—	20,000	12,217	47,217



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**NOTE 12: 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, 2012, 2011, and 2010, is presented below.

<i>(In thousands)</i>	<b>Pre-tax amount</b>	<b>Tax benefit (expense)</b>	<b>Net of tax amount</b>
<b>2012:</b>			
Unrealized net holding gain on all other securities	2,188	(809)	1,379
Reclassification adjustment for net gain on securities recognized in net earnings	(679)	252	(427)
Other comprehensive income	<u>\$ 1,509</u>	<u>(557)</u>	<u>952</u>
<b>2011:</b>			
Unrealized net holding loss on other-than-temporarily impaired securities due to factors other than credit	<u>\$ (130)</u>	<u>48</u>	<u>(82)</u>
Unrealized net holding gain on all other securities	11,187	(4,128)	7,059
Reclassification adjustment for net gain on securities recognized in net earnings	(878)	324	(554)
Other comprehensive income	<u>\$ 10,179</u>	<u>(3,756)</u>	<u>6,423</u>
<b>2010:</b>			
Unrealized net holding loss on other-than-temporarily impaired securities due to factors other than credit	<u>\$ (210)</u>	<u>77</u>	<u>(133)</u>
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	<u>\$ (3,665)</u>	<u>1,353</u>	<u>(2,312)</u>

**NOTE 13: INCOME TAXES**

For the years ended December 31, 2012, 2011, and 2010 the components of income tax expense (benefit) from continuing operations are presented below.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2012	2011	2010
Current income taxes:			
Federal	\$ 737	72	1,290
State	58	353	285
Total current income taxes	795	425	1,575
Deferred income taxes:			
Federal	472	(344)	(698)
State	152	(24)	(79)
Total deferred income taxes	624	(368)	(777)
Total income tax expense	\$ 1,419	57	798

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, 2012, 2011, and 2010, is presented below.

<i>(Dollars in thousands)</i>	2012		2011		2010	
	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings
Earnings before income taxes	\$ 8,182		5,595		6,144	
Income taxes at statutory rate	2,782	34.0 %	1,902	34.0 %	2,089	34.0 %
Tax-exempt interest	(997)	(12.2)	(1,028)	(18.4)	(1,042)	(17.0)
State income taxes, net of federal tax effect	179	2.2	183	3.3	151	2.5
Low-income housing credit	—	—	(891)	(15.9)	(220)	(3.6)
Bank owned life insurance	(151)	(1.8)	(157)	(2.8)	(154)	(2.5)
Change in valuation allowance	(505)	(6.2)	—	—	—	—
Other	111	1.4	48	0.9	(26)	(0.4)
Total income tax expense	\$ 1,419	17.3 %	57	1.0 %	798	13.0 %

The Company had net deferred tax assets of \$1.2 million and \$2.4 million at December 31, 2012 and 2011, 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, 2012 and 2011 are presented below:

(Dollars in thousands)	December 31	
	2012	2011
Deferred tax assets:		
Allowance for loan losses	\$ 2,480	2,553
Premises and equipment	—	3
Other-than-temporary impairment on securities	464	1,209
Write-downs on other real estate owned	489	1,182
Capital loss carry-forwards	—	505
Tax credit carry-forwards	932	277
Other	670	333
Total deferred tax assets	5,035	6,062
Less: valuation allowance for capital loss carry-forwards	—	(505)
Total deferred tax assets less valuation allowance	5,035	5,557
Deferred tax liabilities:		
Premises and equipment	11	—
Unrealized gain on securities	3,025	2,468
Originated mortgage servicing rights	563	459
Other	192	205
Total deferred tax liabilities	3,791	3,132
Net deferred tax asset	\$ 1,244	2,425

At December 31, 2012, the Company had no capital loss carry-forwards compared to approximately \$0.5 million at December 31, 2011.

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.

At December 31, 2012, the Company had no valuation for deferred tax assets compared to \$0.5 million at December 31, 2011, which reduced its deferred tax asset related to capital loss carry-forwards. The capital loss carryforwards at December 31, 2011, 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. In 2012, the Company sold its interests in three affordable housing limited partnerships. Because a large portion of the gain on sale of the limited partnership interests were characterized as capital gains for tax purposes, the Company reversed the previously established deferred tax valuation allowance of \$0.5 million in 2012, which reduced the Company's annual income tax expense for the same period. 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, 2012. 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, 2012, 2011, and 2010, is presented below.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2012	2011	2010
<b>Net deferred tax asset:</b>			
Balance, beginning of year	\$ 2,425	5,813	3,683
Deferred tax (expense) benefit related to continuing operations	(624)	368	777
Stockholders' equity, for accumulated other comprehensive (income) loss	(557)	(3,756)	1,353
Balance, end of year	\$ 1,244	2,425	5,813

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 de-recognition, measurement, and classification of income tax uncertainties in interim periods. As of December 31, 2012, 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 2013 relative to any tax positions taken prior to December 31, 2012. As of December 31, 2012, 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 and the State of Alabama for the years ended December 31, 2009 through 2012.

#### **NOTE 14: 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 \$115 thousand, \$110 thousand, and \$113 thousand for the years ended December 31, 2012, 2011, and 2010, respectively, and are included in salaries and benefits expense.

#### **NOTE 15: 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, 2012, the Company had no derivative contracts to assist in managing its 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 counterparty 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 years ended December 31, 2012 and 2011 is presented below.

		Other Assets	Other Liabilities	Other noninterest income
		Estimated Fair Value	Estimated Fair Value	Gains (Losses)
<i>(Dollars in thousands)</i>				
<b>December 31, 2012:</b>				
Pay fixed / receive variable	\$ 5,367	—	1,210	\$ 115
Pay variable / receive fixed	5,367	1,210	—	(115)
Total interest rate swap agreements	\$ 10,734	1,210	1,210	\$ —
<b>December 31, 2011:</b>				
Pay fixed / receive variable	\$ 5,717	—	1,325	\$ (224)
Pay variable / receive fixed	5,717	1,325	—	224
Total interest rate swap agreements	\$ 11,434	1,325	1,325	\$ —

#### NOTE 16: 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, 2012 and 2011, the following financial instruments were outstanding whose contract amount represents credit risk:

	December 31	
<i>(Dollars in thousands)</i>	2012	2011
Commitments to extend credit	\$ 48,525	\$ 45,882
Standby letters of credit	7,093	8,212

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. 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 \$74 thousand and \$69 thousand at December 31, 2012 and 2011, respectively.

##### *Other Commitments*

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2012, are as follows: 2013, \$298 thousand; 2014, \$179 thousand; 2015, \$137 thousand; 2016, \$95 thousand; 2017, \$45 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 17: FAIR VALUE****Fair Value Hierarchy**

“Fair value” is defined by 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 occurring in the principal market (or most advantageous market in the absence of a principal market) for an asset or liability at the measurement date. GAAP establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is 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, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3—inputs to the valuation methodology are unobservable and reflect the Company’s own assumptions about the inputs market participants would use in pricing the asset or liability.

**Level changes in fair value measurements**

Transfers between levels of the fair value hierarchy are generally recognized at the end of the reporting period. 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 infrequent. For the years ended December 31, 2012 and 2011, there were no transfers between levels and no changes in valuation techniques for the Company’s financial assets and liabilities.

For the year ended December 31, 2010 the company determined that its corporate debt securities should be transferred from Level 2 and classified as Level 1. The company disposed of these 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 securities sold, the Company determined that the trade price for each security approximated its fair value at December 31, 2010. For the year ended December 31, 2010 there were no other transfers between levels.

**Assets and liabilities measured at fair value on a recurring basis*****Securities available-for-sale***

Fair values of securities available for sale were primarily measured using Level 2 inputs. For these securities, the Company obtains pricing from third party pricing services. These third party pricing services consider observable data that may include broker/dealer quotes, market spreads, cash flows, market consensus prepayment speeds, benchmark yields, reported trades, market consensus prepayment speeds, credit information and the securities’ terms and conditions. On a quarterly basis, management reviews the pricing received from the third party pricing services for reasonableness given current market conditions. As part of its review, management may obtain non-binding third party broker quotes to validate the fair value measurements. In addition, management will periodically submit pricing provided by the third party pricing services to another independent valuation firm on a sample basis. This independent valuation firm will compare the price provided by the third party pricing service with its own price and will review the significant assumptions and valuation methodologies used with management.

Fair values of individual issuer trust preferred securities were measured using Level 3 inputs. The valuation of individual issuer trust preferred securities requires significant management judgment due to the absence of observable quoted market prices, inherent lack of liquidity, and the long-term nature of such assets. In order to assist management in making its determination of fair value, the Company engages a third party firm who specializes in valuing illiquid

securities. The third party firm utilizes a discounted cash flow model to estimate the fair value measurements for these securities. In making its final determination of fair value, management reviews the reasonableness of projected cash flows and the credit spread utilized in the discounted cash flow model after evaluating the financial performance of the individual community bank holding companies. The credit spread that is included in the discount rate applied to the projected future cash flows is an unobservable input that is significant to the overall fair value measurement for these securities. Significant increases (decreases) in the credit spread could result in a lower (higher) fair value measurement. Because these trust preferred securities were issued by individual community banks, the credit spread will generally increase when the financial performance of the issuer deteriorates and decrease as the financial performance of the issuer improves.

#### *Interest rate swap agreements*

The carrying amount of interest rate swap agreements was included in other assets and accrued expenses and other liabilities on the accompanying consolidated balance sheets. The fair value measurements for our interest rate swap agreements were based on information obtained from a third party bank. This information is periodically tested by the Company and validated against other third party valuations. If needed, other third party market participants may be utilized to corroborate the fair value measurements for our interest rate swap agreements. The Company classified these derivative assets and liabilities within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments.

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of December 31, 2012 and 2011, respectively, by caption, on the accompanying Consolidated Balance Sheets by FASB ASC 820 valuation hierarchy (as described above).

<i>(Dollars in thousands)</i>	<b>Amount</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b>December 31, 2012:</b>				
Securities available-for-sale:				
Agency obligations	\$ 39,525	—	39,525	—
Agency RMBS	141,460	—	141,460	—
State and political subdivisions	77,838	—	77,838	—
Trust preferred securities	652	—	—	652
Total securities available-for-sale	259,475	—	258,823	652
Other assets <sup>(1)</sup>	1,210	—	1,210	—
<b>Total assets at fair value</b>	<b>\$ 260,685</b>	<b>—</b>	<b>260,033</b>	<b>652</b>
Other liabilities <sup>(1)</sup>	1,210	—	1,210	—
<b>Total liabilities at fair value</b>	<b>\$ 1,210</b>	<b>—</b>	<b>1,210</b>	<b>—</b>
<b>December 31, 2011:</b>				
Securities available-for-sale:				
Agency obligations	\$ 51,085	—	51,085	—
Agency RMBS	164,798	—	164,798	—
State and political subdivisions	81,713	—	81,713	—
Trust preferred securities	1,986	—	—	1,986
Total securities available-for-sale	299,582	—	297,596	1,986
Other assets <sup>(1)</sup>	1,325	—	1,325	—
<b>Total assets at fair value</b>	<b>\$ 300,907</b>	<b>—</b>	<b>298,921</b>	<b>1,986</b>
Other liabilities <sup>(1)</sup>	1,325	—	1,325	—
<b>Total liabilities at fair value</b>	<b>\$ 1,325</b>	<b>—</b>	<b>1,325</b>	<b>—</b>

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

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

### *Loans held for sale*

Loans held for sale are carried at the lower of cost or fair value. Fair values of loans held for sale are determined using quoted market secondary market prices for similar loans. Loans held for sale are classified within Level 2 of the fair value hierarchy.

### *Impaired Loans*

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 principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be 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 less selling costs if the loan is collateral dependent.

The fair value of impaired loans were primarily measured based on the value of the collateral securing these loans. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. The Company determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted based on management's historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

### *Other real estate owned*

Other real estate owned, 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 values are generally based on third party appraisals of the property, resulting in a Level 3 classification. The appraisals are sometimes further discounted based on management's historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts are typically significant unobservable inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, a loss is recognized in noninterest expense.

### *Mortgage servicing rights, net*

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. MSRs do not trade in an active market with readily observable prices. To determine the fair value of MSRs, 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. Periodically, the Company will review broker surveys and other market research to validate significant assumptions used in the model. The significant unobservable inputs include prepayment speeds or the constant prepayment rate ("CPR") and the weighted average discount rate. Because the valuation of MSRs requires the use of significant unobservable inputs, all of the Company's MSRs are classified within Level 3 of the valuation hierarchy.



The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2012 and 2011, respectively, by caption, on the accompanying Consolidated Balance Sheets and by FASB ASC 820 valuation hierarchy (as described above):

		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>(Dollars in thousands)</i>	<b>Amount</b>			
<b>December 31, 2012:</b>				
Loans held for sale	\$ 2,887	—	2,887	—
Loans, net <sup>(1)</sup>	10,272	—	—	10,272
Other real estate owned	4,919	—	—	4,919
Other assets <sup>(2)</sup>	1,526	—	—	1,526
Total assets at fair value	\$ 19,604	—	2,887	16,717
<b>December 31, 2011:</b>				
Loans held for sale	\$ 3,346	—	3,346	—
Loans, net <sup>(1)</sup>	9,765	—	—	9,765
Other real estate owned	7,898	—	—	7,898
Other assets <sup>(2)</sup>	1,245	—	—	1,245
Total assets at fair value	\$ 22,254	—	3,346	18,908

<sup>(1)</sup>Loans considered impaired under FASB ASC 310-10-35 Receivables. This amount reflects the recorded investment in impaired loans, net of any related allowance for loan losses.

<sup>(2)</sup>Represents the carrying value of MSRs, net.

### Quantitative Disclosures for Level 3 Fair Value Measurements

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements for trust preferred securities recognized in the accompanying Consolidated Balance Sheets using Level 3 inputs:

	Year ended December 31		
<i>(Dollars in thousands)</i>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Beginning balance	\$ 1,986	\$ 2,149	\$ 1,463
Total realized and unrealized gains and (losses):			
Included in net earnings	(6)	(338)	(1,218)
Included in other comprehensive income	146	175	1,904
Sales	(974)	—	—
Settlements	(500)	—	—
Ending balance	\$ 652	\$ 1,986	\$ 2,149

For Level 3 assets measured at fair value on a recurring or non-recurring basis as of December 31, 2012, the significant unobservable inputs used in the fair value measurements are presented below.

<i>(Dollars in thousands)</i>	Carrying Amount	Valuation Technique	Significant Unobservable Input	Weighted Average of Input
<b>Recurring:</b>				
Trust preferred securities	\$ 652	Discounted cash flow	Credit spread (basis points)	643 bp
<b>Nonrecurring:</b>				
Impaired loans	\$ 10,272	Appraisal	Appraisal discounts (%)	6.8 %
Other real estate owned	4,919	Appraisal	Appraisal discounts (%)	9.8 %
Mortgage servicing rights, net	1,526	Discounted cash flow	Prepayment speed or CPR (%)	23.7 %
			Discount rate (%)	11.0 %

### 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 analyses. 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 are 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:

#### *Loans, net*

Fair values for loans were calculated using discounted cash flows. The discount rates reflected current rates at which similar loans would be made for the same remaining maturities. 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. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

#### *Time Deposits*

Fair values for time deposits were estimated using discounted cash flows. The discount rates were based on rates currently offered for deposits with similar remaining maturities.

#### *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.

The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company's financial instruments at December 31, 2012 and 2011 are presented below. This table excludes financial instruments for which the carrying amount approximates fair value. Financial assets for which fair value approximates carrying value included cash and cash equivalents. Financial liabilities for which fair value approximates carrying value included noninterest-bearing demand, interest-bearing demand, and savings deposits due to these products having no stated maturity and short-term borrowings.

(Dollars in thousands)	Carrying amount	Estimated fair value	Fair Value Hierarchy							
			Level 1 inputs		Level 2 inputs		Level 3 Inputs			
<b>December 31, 2012:</b>										
Financial Assets:										
Loans, net (1)	\$	391,470	\$	399,533	\$	—	\$	—	\$	399,533
Financial Liabilities:										
Time Deposits	\$	263,195	\$	267,636	\$	—	\$	267,636	\$	—
Long-term debt		47,217		51,752		—		51,752		—
<b>December 31, 2011:</b>										
Financial Assets:										
Loans, net (1)	\$	363,344	\$	371,433	\$	—	\$	—	\$	371,433
Financial Liabilities:										
Time Deposits	\$	281,362	\$	286,644	\$	—	\$	286,644	\$	—
Long-term debt		85,313		93,360		—		93,360		—

(1) Represents loans, net of unearned income and the allowance for loan losses.

#### NOTE 18: RELATED PARTY TRANSACTIONS

A director of the Company is an officer in a construction company that the Company contracted with during 2012 and 2011 for the construction of a new branch facility in Valley, Alabama and the construction of a new drive-through banking facility and completion of other site work on the Bank's main office campus in Auburn, Alabama. Total payments made to the construction company under the terms of the construction contracts were \$1.2 million and \$0.8 million for the years ended December 31, 2012 and 2011, respectively.

Another executive officer and director of the Company is the owner of a heating and air conditioning company that the Company contracted with during 2011 for the replacement and improvement of the heating and cooling systems in the Bank's 23,000 square foot operations center. Total payments made to the heating and air conditioning company under the terms of the contract were \$82 thousand and \$200 thousand for the years ended December 31, 2012 and 2011, respectively.

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.

(Dollars in thousands)	Amount
Loans outstanding at December 31, 2011	\$ 5,450
New loans/advances	3,858
Repayments	(3,442)
Changes in directors and executive officers	(461)
Loans outstanding at December 31, 2012	\$ 5,405

During 2012 and 2011, 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, 2012 and 2011 amounted to \$19.1 million and \$18.4 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, 2012, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2012, 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's 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, 2012 and 2011 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, 2012:</b>							
Tier 1 Leverage Capital							
Auburn National Bancorporation	\$ 71,982	9.58 %	\$ 30,069	4.00 %		N/A	N/A
AuburnBank	71,277	9.50	30,011	4.00	\$	37,514	5.00 %
Tier 1 Risk-Based Capital							
Auburn National Bancorporation	\$ 71,982	16.20 %	\$ 17,768	4.00 %		N/A	N/A
AuburnBank	71,277	16.02	17,794	4.00	\$	26,691	6.00 %
Total Risk-Based Capital							
Auburn National Bancorporation	\$ 77,558	17.46 %	\$ 35,536	8.00 %		N/A	N/A
AuburnBank	76,853	17.28	35,588	8.00	\$	44,485	10.00 %
<b>At December 31, 2011:</b>							
Tier 1 Leverage Capital							
Auburn National Bancorporation	\$ 68,220	8.82 %	\$ 30,927	4.00 %		N/A	N/A
AuburnBank	67,542	8.75	30,868	4.00	\$	38,585	5.00 %
Tier 1 Risk-Based Capital							
Auburn National Bancorporation	\$ 68,220	15.40 %	\$ 17,715	4.00 %		N/A	N/A
AuburnBank	67,542	15.23	17,742	4.00	\$	26,614	6.00 %
Total Risk-Based Capital							
Auburn National Bancorporation	\$ 73,800	16.66 %	\$ 35,430	8.00 %		N/A	N/A
AuburnBank	73,122	16.49	35,485	8.00	\$	44,356	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, 2012, the Bank could have declared additional dividends of approximately \$9.0 million without prior approval of regulatory authorities. As a result of this limitation, approximately \$67.5 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

<i>(Dollars in thousands)</i>	December 31	
	2012	2011
<b>Assets:</b>		
Cash and due from banks	\$ 1,316	1,369
Investment in bank subsidiary	76,547	71,842
Premises and equipment	158	170
Other assets	1,162	1,178
Total assets	\$ 79,183	74,559
<b>Liabilities:</b>		
Accrued expenses and other liabilities	\$ 1,817	1,926
Long-term debt	7,217	7,217
Total liabilities	9,034	9,143
Stockholders' equity	70,149	65,416
Total liabilities and stockholders' equity	\$ 79,183	74,559

### CONDENSED STATEMENTS OF EARNINGS

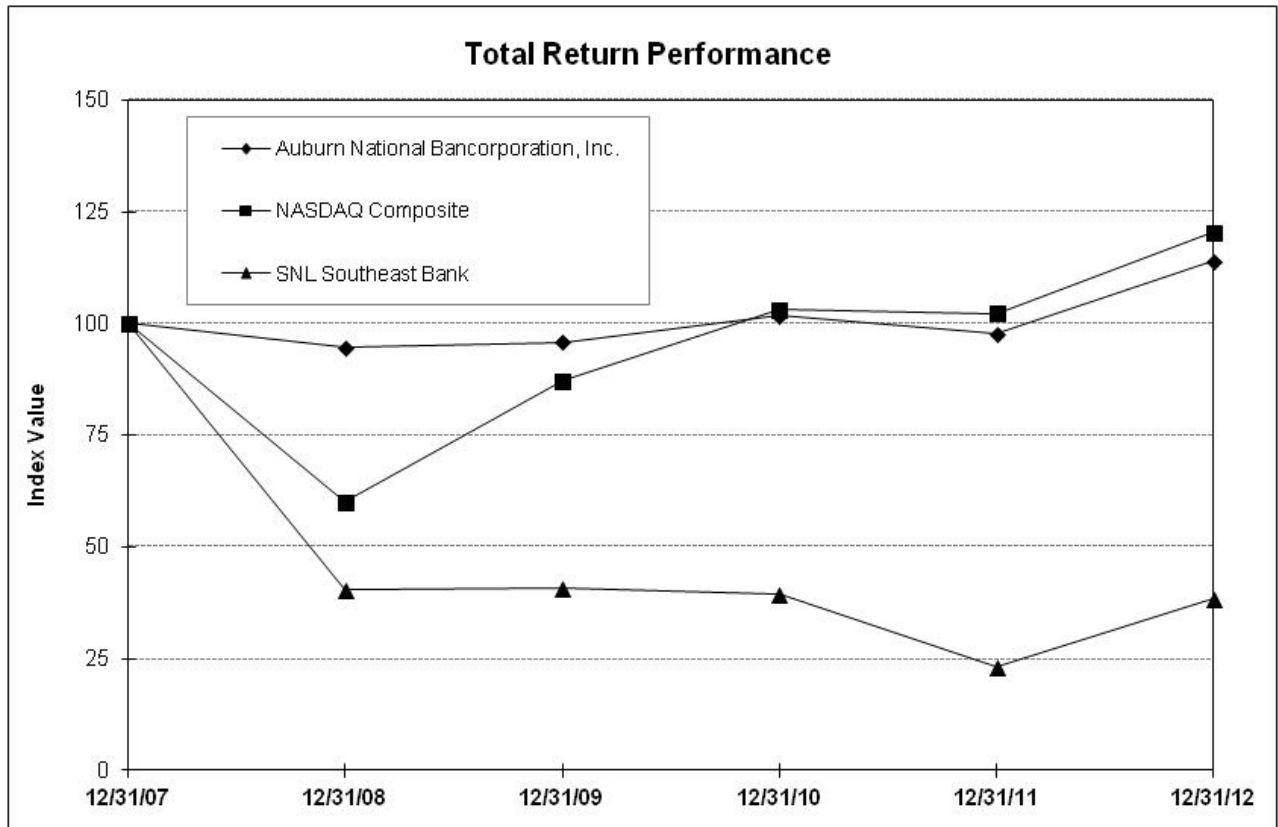
<i>(Dollars in thousands)</i>	Year ended December 31		
	2012	2011	2010
<b>Income:</b>			
Dividends from bank subsidiary	\$ 3,231	3,158	3,085
Noninterest income	288	385	417
Total income	3,519	3,543	3,502
<b>Expense:</b>			
Interest expense	236	236	236
Noninterest expense	318	485	577
Total expense	554	721	813
Earnings before income tax benefit and equity in undistributed earnings of bank subsidiary	2,965	2,822	2,689
Income tax benefit	(45)	(31)	(65)
Earnings before equity in undistributed earnings of bank subsidiary	3,010	2,853	2,754
Equity in undistributed earnings of bank subsidiary	3,753	2,685	2,592
<b>Net earnings</b>	\$ 6,763	5,538	5,346

## CONDENSED STATEMENTS OF CASH FLOWS

	Year ended December 31		
	2012	2011	2010
<i>(Dollars in thousands)</i>			
<b>Cash flows from operating activities:</b>			
Net earnings	\$ 6,763	5,538	5,346
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	29	80	106
Net decrease in other assets	16	22	16
Net (decrease) increase in other liabilities	(109)	(727)	32
Equity in undistributed earnings of bank subsidiary	(3,753)	(2,685)	(2,592)
Net cash provided by operating activities	2,946	2,228	2,908
<b>Cash flows from investing activities:</b>			
Purchases of premises and equipment	(17)	—	(20)
Proceeds from sale of premises and equipment to bank subsidiary	—	4,450	—
Capital contribution to bank subsidiary	—	(3,200)	—
Net cash (used in) provided by investing activities	(17)	1,250	(20)
<b>Cash flows from financing activities:</b>			
Stock repurchases	—	—	(9)
Proceeds from sale of treasury stock	5	1	2
Dividends paid	(2,987)	(2,914)	(2,842)
Net cash used in financing activities	(2,982)	(2,913)	(2,849)
Net change in cash and cash equivalents	(53)	565	39
Cash and cash equivalents at beginning of period	1,369	804	765
<b>Cash and cash equivalents at end of period</b>	<b>\$ 1,316</b>	<b>1,369</b>	<b>804</b>

## STOCK PERFORMANCE GRAPH

The following performance graph compares the cumulative, total return on the Company's Common Stock from December 31, 2007 to December 31, 2012, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a \$100 investment on December 31, 2007). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.



<i>Index</i>	<i>Period Ending</i>					
	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12
Auburn National Bancorporation, Inc.	100.00	94.60	95.83	101.63	97.70	114.02
NASDAQ Composite	100.00	60.02	87.24	103.08	102.26	120.42
SNL Southeast Bank	100.00	40.48	40.65	39.47	23.09	38.36

# 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  
Wells Fargo Tower  
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 14, 2013  
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 [investor-relations@auburnbank.com](mailto:investor-relations@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.





AUBURN BANK

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