

AUBURN NATIONAL BANCORPORATION, INC

Form 10-Q

August 02, 2013

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**(Mark One)**

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended June 30, 2013

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the transition period \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-26486

**Auburn National Bancorporation, Inc.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**100 N. Gay Street**

**63-0885779**  
(I.R.S. Employer  
Identification No.)

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Auburn, Alabama 36830

(334) 821-9200

(Address and telephone number of principal executive offices)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes

No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                                    | Outstanding at July 31, 2013 |
|--|------------------------------|
| Common Stock, \$0.01 par value per share | 3,643,013 shares             |

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**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**

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**Table of Contents****PART 1. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Balance Sheets****(Unaudited)**

*(Dollars in thousands, except share data)*

|   | <b>June 30,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|---|--------------------------|------------------------------|
| <b>Assets:</b>  |                          |                              |
| Cash and due from banks   | \$ 17,015                | \$ 18,762                    |
| Federal funds sold  | 38,710                   | 42,682                       |
| Interest bearing bank deposits  | 6,813                    | 505                          |
| <b>Cash and cash equivalents</b>  | <b>62,538</b>            | <b>61,949</b>                |
| Securities available-for-sale   | 270,794                  | 259,475                      |
| Loans held for sale   | 4,824                    | 2,887                        |
| Loans, net of unearned income   | 390,726                  | 398,193                      |
| Allowance for loan losses   | (6,457)                  | (6,723)                      |
| <b>Loans, net</b>   | <b>384,269</b>           | <b>391,470</b>               |
| Premises and equipment, net   | 10,790                   | 10,528                       |
| Bank-owned life insurance   | 17,272                   | 17,076                       |
| Other real estate owned   | 3,609                    | 4,919                        |
| Other assets  | 13,651                   | 11,529                       |
| <b>Total assets</b>   | <b>\$ 767,747</b>        | <b>\$ 759,833</b>            |
| <b>Liabilities:</b>   |                          |                              |
| Deposits:   |                          |                              |
| Noninterest-bearing   | \$ 127,189               | \$ 118,014                   |
| Interest-bearing  | 539,301                  | 518,803                      |
| <b>Total deposits</b>   | <b>666,490</b>           | <b>636,817</b>               |
| Federal funds purchased and securities sold under agreements to repurchase            | 4,953                    | 2,689                        |
| Long-term debt  | 27,217                   | 47,217                       |
| Accrued expenses and other liabilities  | 3,876                    | 2,961                        |
| <b>Total liabilities</b>  | <b>702,536</b>           | <b>689,684</b>               |
| <b>Stockholders equity:</b>   |                          |                              |
| Preferred stock of \$.01 par value; authorized 200,000 shares; no issued shares       |                          |                              |
| Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares | 39                       | 39                           |
| Additional paid-in capital  | 3,757                    | 3,756                        |
| Retained earnings   | 69,887                   | 67,821                       |
| Accumulated other comprehensive (loss) income, net                                    | (1,831)                  | 5,174                        |

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|   |            |            |
|---|------------|------------|
| Less treasury stock, at cost 314,142 shares and 314,232 shares at June 30, 2013 and December 31, 2012, respectively | (6,641)    | (6,641)    |
| Total stockholders' equity  | 65,211     | 70,149     |
| Total liabilities and stockholders' equity  | \$ 767,747 | \$ 759,833 |

*See accompanying notes to consolidated financial statements*

**Table of Contents****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Statements of Earnings****(Unaudited)**

| <i>(In thousands, except share and per share data)</i>     | <b>Quarters ended June 30,</b> |              | <b>Six months ended June 30,</b> |               |
|--|--------------------------------|--------------|----------------------------------|---------------|
|  | <b>2013</b>                    | <b>2012</b>  | <b>2013</b>                      | <b>2012</b>   |
| <b>Interest income:</b>                                    |                                |              |                                  |               |
| Loans, including fees                                      | \$ 5,224                       | \$ 5,490     | \$ 10,552                        | \$ 10,755     |
| Securities   | 1,607                          | 1,860        | 3,223                            | 3,829         |
| Federal funds sold and interest bearing bank deposits      | 29                             | 7            | 60                               | 21            |
| Total interest income                                      | 6,860                          | 7,357        | 13,835                           | 14,605        |
| <b>Interest expense:</b>                                   |                                |              |                                  |               |
| Deposits   | 1,349                          | 1,605        | 2,753                            | 3,330         |
| Short-term borrowings                                      | 3                              | 5            | 7                                | 9             |
| Long-term debt   | 276                            | 435          | 702                              | 953           |
| Total interest expense                                     | 1,628                          | 2,045        | 3,462                            | 4,292         |
| <b>Net interest income</b>                                 | <b>5,232</b>                   | <b>5,312</b> | <b>10,373</b>                    | <b>10,313</b> |
| <b>Provision for loan losses</b>                           |                                | <b>600</b>   | <b>400</b>                       | <b>1,200</b>  |
| <b>Net interest income after provision for loan losses</b> | <b>5,232</b>                   | <b>4,712</b> | <b>9,973</b>                     | <b>9,113</b>  |
| <b>Noninterest income:</b>                                 |                                |              |                                  |               |
| Service charges on deposit accounts                        | 234                            | 279          | 483                              | 570           |
| Mortgage lending   | 837                            | 785          | 1,647                            | 1,454         |
| Bank-owned life insurance                                  | 101                            | 113          | 196                              | 212           |
| Gain on sale of affordable housing investments             |                                |              |                                  | 3,268         |
| Other  | 381                            | 386          | 721                              | 744           |
| Securities gains, net:                                     |                                |              |                                  |               |
| Realized gains, net  | 518                            | 251          | 679                              | 560           |
| Total other-than-temporary impairments                     |                                |              |                                  | (130)         |
| Total securities gains, net                                | 518                            | 251          | 679                              | 430           |
| Total noninterest income                                   | 2,071                          | 1,814        | 3,726                            | 6,678         |
| <b>Noninterest expense:</b>                                |                                |              |                                  |               |
| Salaries and benefits                                      | 2,114                          | 2,205        | 4,364                            | 4,348         |
| Net occupancy and equipment                                | 333                            | 336          | 664                              | 674           |
| Professional fees  | 209                            | 188          | 385                              | 375           |
| FDIC and other regulatory assessments                      | 143                            | 185          | 337                              | 368           |
| Other real estate owned, net                               | 20                             | (6)          | 43                               | 63            |
| Prepayment penalty on long-term debt                       | 1,046                          | 12           | 1,471                            | 3,720         |
| Other  | 859                            | 1,128        | 1,686                            | 2,042         |
| Total noninterest expense                                  | 4,724                          | 4,048        | 8,950                            | 11,590        |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Earnings before income taxes                | 2,579     | 2,478     | 4,749     | 4,201     |
| <b>Income tax expense</b>                   | 672       | 449       | 1,153     | 707       |
| <b>Net earnings</b>                         | \$ 1,907  | \$ 2,029  | \$ 3,596  | \$ 3,494  |
| <b>Net earnings per share:</b>              |           |           |           |           |
| Basic and diluted                           | \$ 0.52   | \$ 0.56   | \$ 0.99   | \$ 0.96   |
| <b>Weighted average shares outstanding:</b> |           |           |           |           |
| Basic and diluted                           | 3,642,955 | 3,642,826 | 3,642,936 | 3,642,782 |

*See accompanying notes to consolidated financial statements*

**Table of Contents****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income****(Unaudited)**

| <i>(Dollars in thousands)</i>   | <b>Quarters ended June 30,</b> |                 | <b>Six months ended June 30,</b> |                 |
|---|--------------------------------|-----------------|----------------------------------|-----------------|
|   | <b>2013</b>                    | <b>2012</b>     | <b>2013</b>                      | <b>2012</b>     |
| <b>Net earnings</b>   | \$ 1,907                       | \$ 2,029        | \$ 3,596                         | \$ 3,494        |
| <b>Other comprehensive (loss) income, net of tax:</b>                             |                                |                 |                                  |                 |
| Unrealized net holding (loss) gain on securities                                  | (5,821)                        | 1,195           | (6,577)                          | 1,145           |
| Reclassification adjustment for net gain on securities recognized in net earnings | (327)                          | (158)           | (428)                            | (271)           |
| Other comprehensive (loss) income   | (6,148)                        | 1,037           | (7,005)                          | 874             |
| <b>Comprehensive (loss) income</b>  | <b>\$ (4,241)</b>              | <b>\$ 3,066</b> | <b>\$ (3,409)</b>                | <b>\$ 4,368</b> |

*See accompanying notes to consolidated financial statements*



**Table of Contents****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Statements of Stockholders' Equity****(Unaudited)**

|  | Common Stock |        | Additional<br>paid-in<br>capital | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income (loss) | Treasury<br>stock | Total     |
|--|--------------|--------|----------------------------------|----------------------|--|-------------------|-----------|
|  | Shares       | Amount |                                  |                      |  |                   |           |
| <i>(Dollars in thousands, except share data)</i> |              |        |                                  |                      |  |                   |           |
| <b>Balance, December 31, 2011</b>                | 3,957,135    | \$ 39  | \$ 3,753                         | \$ 64,045            | \$ 4,222   | \$ (6,643)        | \$ 65,416 |
| Net earnings                                     |              |        |                                  | 3,494                |  |                   | 3,494     |
| Other comprehensive income                       |              |        |                                  |                      | 874  |                   | 874       |
| Cash dividends paid (\$0.41 per share)           |              |        |                                  | (1,494)              |  |                   | (1,494)   |
| Sale of treasury stock (105 shares)              |              |        |                                  | 1                    |  | 1                 | 2         |
| <b>Balance, June 30, 2012</b>                    | 3,957,135    | \$ 39  | \$ 3,754                         | \$ 66,045            | \$ 5,096   | \$ (6,642)        | \$ 68,292 |
| <b>Balance, December 31, 2012</b>                | 3,957,135    | \$ 39  | \$ 3,756                         | \$ 67,821            | \$ 5,174   | \$ (6,641)        | \$ 70,149 |
| Net earnings                                     |              |        |                                  | 3,596                |  |                   | 3,596     |
| Other comprehensive loss                         |              |        |                                  |                      | (7,005)  |                   | (7,005)   |
| Cash dividends paid (\$0.42 per share)           |              |        |                                  | (1,530)              |  |                   | (1,530)   |
| Sale of treasury stock (90 shares)               |              |        |                                  | 1                    |  |                   | 1         |
| <b>Balance, June 30, 2013</b>                    | 3,957,135    | \$ 39  | \$ 3,757                         | \$ 69,887            | \$ (1,831)   | \$ (6,641)        | \$ 65,211 |

*See accompanying notes to consolidated financial statements*

**Table of Contents****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows****(Unaudited)**

| <i>(In thousands)</i>   | <b>Six months ended June 30,</b> |             |
|---|----------------------------------|-------------|
|   | <b>2013</b>                      | <b>2012</b> |
| <b>Cash flows from operating activities:</b>  |                                  |             |
| Net earnings  | \$ 3,596                         | \$ 3,494    |
| Adjustments to reconcile net earnings to net cash provided by operating activities:                   |                                  |             |
| Provision for loan losses   | 400                              | 1,200       |
| Depreciation and amortization   | 448                              | 403         |
| Premium amortization and discount accretion, net  | 1,143                            | 1,590       |
| Net gain on securities available for sale   | (679)                            | (430)       |
| Net gain on sale of loans held for sale   | (1,258)                          | (1,416)     |
| Net (gain) loss on other real estate owned  | (47)                             | 25          |
| Loss on prepayment of long-term debt  | 1,471                            | 3,720       |
| Loans originated for sale   | (61,382)                         | (64,433)    |
| Proceeds from sale of loans   | 60,225                           | 62,013      |
| Increase in cash surrender value of bank owned life insurance   | (196)                            | (212)       |
| Gain on sale of affordable housing partnership investments  |                                  | (3,268)     |
| Net decrease in other assets  | 1,061                            | 300         |
| Net increase (decrease) in accrued expenses and other liabilities                                     | 915                              | (22)        |
| Net cash provided by operating activities   | 5,697                            | 2,964       |
| <b>Cash flows from investing activities:</b>  |                                  |             |
| Proceeds from sales of securities available-for-sale  | 37,859                           | 39,344      |
| Proceeds from maturities of securities available-for-sale   | 39,179                           | 68,088      |
| Purchase of securities available-for-sale   | (99,923)                         | (84,871)    |
| Decrease (increase) in loans, net   | 6,159                            | (31,046)    |
| Net purchases of premises and equipment   | (471)                            | (740)       |
| Decrease in FHLB stock  | 1,153                            | 1,607       |
| Proceeds from sale of affordable housing limited partnerships   |                                  | 8,499       |
| Proceeds from sale of other real estate owned   | 1,999                            | 3,039       |
| Net cash (used in) provided by investing activities   | (14,045)                         | 3,920       |
| <b>Cash flows from financing activities:</b>  |                                  |             |
| Net increase in noninterest-bearing deposits  | 9,175                            | 7,201       |
| Net increase in interest-bearing deposits   | 20,498                           | 17,493      |
| Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase | 2,264                            | (20)        |
| Repayments or retirement of long-term debt  | (21,471)                         | (41,816)    |
| Proceeds from sale of treasury stock  | 1                                | 2           |
| Dividends paid  | (1,530)                          | (1,494)     |
| Net cash provided by (used in) financing activities   | 8,937                            | (18,634)    |
| Net change in cash and cash equivalents   | 589                              | (11,750)    |
| Cash and cash equivalents at beginning of period  | 61,949                           | 55,428      |

|   |           |           |
|---|-----------|-----------|
| <b>Cash and cash equivalents at end of period</b> | \$ 62,538 | \$ 43,678 |
|---|-----------|-----------|

**Supplemental disclosures of cash flow information:**

Cash paid during the period for:

|              |          |          |
|--------------|----------|----------|
| Interest     | \$ 3,548 | \$ 4,507 |
| Income taxes | 254      | 667      |

**Supplemental disclosure of non-cash transactions:**

|  |     |     |
|--|-----|-----|
| Real estate acquired through foreclosure | 642 | 323 |
|--|-----|-----|

*See accompanying notes to consolidated financial statements*

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**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

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

**General**

Auburn National Bancorporation, Inc. (the Company) provides a full range of banking services to individual and corporate customers in Lee County, Alabama and surrounding counties through its wholly owned subsidiary, AuburnBank (the Bank). The Company does not have any segments other than banking that are considered material.

**Basis of Presentation and Use of Estimates**

The unaudited consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The unaudited consolidated financial statements include, in the opinion of management, all adjustments necessary to present a fair statement of the financial position and the results of operations for all periods presented. All such adjustments are of a normal recurring nature. The results of operations in the interim statements are not necessarily indicative of the results of operations that the Company and its subsidiaries may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company's annual report on Form 10-K for the year ended December 31, 2012.

The unaudited 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 unaudited consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses 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 other-than-temporary impairment on investment securities, the determination of the allowance for loan losses, fair value of financial instruments, and the valuation of deferred tax assets and other real estate owned.

**Subsequent Events**

The Company has evaluated the effects of events and transactions through the date of this filing that have occurred subsequent to June 30, 2013. The Company does not believe there were any material subsequent events during this period that would have required recognition or disclosure in the unaudited consolidated financial statements included in this report.

**Accounting Developments**

In the first quarter of 2013, the Company adopted new guidance related to the following Codification topics:

ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*;

ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*; and

ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*.



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Information about these pronouncements are 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 were effective for the Company in the first quarter of 2013 with retrospective application. Adoption of this ASU did not have a significant impact on the financial statements of the Company.

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 were effective for the Company in the first quarter of 2013 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.

**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 quarter and six month periods ended June 30, 2013 and 2012, respectively. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company's common stock. At June 30, 2013 and 2012, respectively, the Company had no such securities or rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted earnings per share calculation.

The basic and diluted earnings per share computation for the quarter and six month periods ended June 30, 2013 and 2012 is presented below.

| <i>(In thousands, except share and per share data)</i> | <b>Quarter ended June 30,</b> |             | <b>Six months ended June 30,</b> |             |
|--|-------------------------------|-------------|----------------------------------|-------------|
|  | <b>2013</b>                   | <b>2012</b> | <b>2013</b>                      | <b>2012</b> |
| <b>Basic and diluted:</b>                              |                               |             |                                  |             |
| Net earnings   | \$ 1,907                      | \$ 2,029    | \$ 3,596                         | \$ 3,494    |
| Weighted average common shares outstanding             | 3,642,955                     | 3,642,826   | 3,642,936                        | 3,642,782   |
| Earnings per share                                     | \$ 0.52                       | \$ 0.56     | \$ 0.99                          | \$ 0.96     |

**Table of Contents****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 June 30, 2013, 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 of \$0.2 million 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.

The following table summarizes VIEs that are not consolidated by the Company as of June 30, 2013.

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

**Table of Contents****NOTE 4: SECURITIES**

At June 30, 2013 and December 31, 2012, respectively, all securities within the scope of 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 June 30, 2013 and December 31, 2012, respectively, are presented below.

| <i>(Dollars in thousands)</i>    | <b>1 year<br/>or less</b> | <b>1 to 5<br/>years</b> | <b>5 to 10<br/>years</b> | <b>After 10<br/>years</b> | <b>Fair<br/>Value</b> | <b>Gross Unrealized<br/>Gains      Losses</b> |       | <b>Amortized<br/>Cost</b> |
|----------------------------------|---------------------------|-------------------------|--------------------------|---------------------------|-----------------------|---|-------|---------------------------|
| <b>June 30, 2013</b>             |                           |                         |                          |                           |                       |   |       |                           |
| Agency obligations (a)           | \$                        |                         | 24,001                   | 22,614                    | 46,615                | 22  | 2,480 | \$ 49,073                 |
| Agency RMBS (a)                  |                           |                         | 3,968                    | 149,995                   | 153,963               | 938   | 3,416 | 156,441                   |
| State and political subdivisions |                           | 1,846                   | 20,149                   | 47,527                    | 69,522                | 2,341   | 309   | 67,490                    |
| Trust preferred securities       |                           |                         |                          | 694                       | 694                   | 137   | 136   | 693                       |
| Total available-for-sale         | \$                        | 1,846                   | 48,118                   | 220,830                   | 270,794               | 3,438   | 6,341 | \$ 273,697                |
| <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               | 8,534   | 335   | \$ 251,276                |

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

Securities with aggregate fair values of \$145.8 million and \$134.0 million at June 30, 2013 and December 31, 2012, 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 are cost-method investments. The carrying amounts of cost-method investments were \$1.8 million and \$3.0 million at June 30, 2013 and December 31, 2012, 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 June 30, 2013 and December 31, 2012, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer, are presented below.

| <i>(Dollars in thousands)</i> | <b>Less than 12 Months</b> |                              | <b>12 Months or Longer</b> |                              | <b>Total</b>          |                              |
|-------------------------------|----------------------------|------------------------------|----------------------------|------------------------------|-----------------------|------------------------------|
|                               | <b>Fair<br/>Value</b>      | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b>      | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> | <b>Unrealized<br/>Losses</b> |

**June 30, 2013:**



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|                                  |            |       |     |     |            |       |
|----------------------------------|------------|-------|-----|-----|------------|-------|
| Agency obligations               | \$ 41,593  | 2,480 |     |     | \$ 41,593  | 2,480 |
| Agency RMBS                      | 108,049    | 3,416 |     |     | 108,049    | 3,416 |
| State and political subdivisions | 7,381      | 309   |     |     | 7,381      | 309   |
| Trust preferred securities       |            |       | 364 | 136 | \$ 364     | 136   |
| Total                            | \$ 157,023 | 6,205 | 364 | 136 | \$ 157,387 | 6,341 |
| <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   |

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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. On a quarterly basis, 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*

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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 June 30, 2013, cost-method investments with an aggregate cost of \$1.8 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

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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.

**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 has recognized the credit component of the loss in earnings (referred to as credit-impaired debt securities). Other-than-temporary impairments recognized in earnings 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 for the quarters and six months ended June 30, 2013 and 2012 were as follows:

| <i>(Dollars in thousands)</i>                      | <b>Quarter ended June 30,</b> |             | <b>Six months ended June 30,</b> |             |
|--|-------------------------------|-------------|----------------------------------|-------------|
|  | <b>2013</b>                   | <b>2012</b> | <b>2013</b>                      | <b>2012</b> |
| Balance, beginning of period                       | \$ 1,257                      | \$ 1,257    | \$ 1,257                         | \$ 3,276    |
| <b>Additions:</b>                                  |                               |             |                                  |             |
| Subsequent credit impairments                      |                               |             |                                  | 130         |
| <b>Reductions:</b>                                 |                               |             |                                  |             |
| Securities sold                                    |                               |             |                                  | 2,149       |
| Securities fully written down and deemed worthless | 500                           |             | 500                              |             |
| Balance, end of period                             | \$ 757                        | \$ 1,257    | \$ 757                           | \$ 1,257    |

**Other-Than-Temporary Impairment**

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

| <i>(Dollars in thousands)</i>  | <b>Quarter ended June 30,</b> |             | <b>Six months ended June 30,</b> |             |
|--|-------------------------------|-------------|----------------------------------|-------------|
|  | <b>2013</b>                   | <b>2012</b> | <b>2013</b>                      | <b>2012</b> |
| <b>Other-than-temporary impairment charges (included in earnings):</b> |                               |             |                                  |             |
| <b>Debt securities:</b>  |                               |             |                                  |             |
| Individual issuer trust preferred securities                           | \$                            | \$          | \$                               | \$ 130      |
| Total debt securities  |                               |             |                                  | 130         |
| Total other-than-temporary impairment charges                          | \$                            | \$          | \$                               | \$ 130      |
| <b>Other-than-temporary impairment on debt securities:</b>             |                               |             |                                  |             |
| Recorded as part of gross realized losses:                             |                               |             |                                  |             |
| Credit-related   | \$                            | \$          | \$                               | \$ 130      |
| Total other-than-temporary impairment on debt securities               | \$                            | \$          | \$                               | \$ 130      |

**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.

| <i>(Dollars in thousands)</i>           | <b>Quarter ended June 30,</b> |               | <b>Six months ended June 30,</b> |               |
|---|-------------------------------|---------------|----------------------------------|---------------|
|   | <b>2013</b>                   | <b>2012</b>   | <b>2013</b>                      | <b>2012</b>   |
| Gross realized gains                    | \$ 524                        | \$ 251        | \$ 685                           | \$ 724        |
| Gross realized losses                   | (6)                           |               | (6)                              | (164)         |
| Other-than-temporary impairment charges |                               |               |                                  | (130)         |
| <b>Realized gains, net</b>              | <b>\$ 518</b>                 | <b>\$ 251</b> | <b>\$ 679</b>                    | <b>\$ 430</b> |

**Table of Contents****NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES**

| <i>(In thousands)</i>             | June 30,<br>2013 | December 31,<br>2012 |
|-----------------------------------|------------------|----------------------|
| Commercial and industrial         | \$ 56,030        | \$ 59,334            |
| Construction and land development | 45,886           | 37,631               |
| Commercial real estate:           |                  |                      |
| Owner occupied                    | 60,140           | 64,368               |
| Other                             | 117,151          | 119,243              |
| Total commercial real estate      | 177,291          | 183,611              |
| Residential real estate:          |                  |                      |
| Consumer mortgage                 | 55,192           | 58,087               |
| Investment property               | 43,829           | 47,544               |
| Total residential real estate     | 99,021           | 105,631              |
| Consumer installment              | 12,747           | 12,219               |
| Total loans                       | 390,975          | 398,426              |
| Less: unearned income             | (249)            | (233)                |
| Loans, net of unearned income     | \$ 390,726       | \$ 398,193           |

Loans secured by real estate were approximately 82.4% of the Company's total loan portfolio at June 30, 2013. At June 30, 2013, 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 and classes.

*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.

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*Other* primarily includes loans to finance income-producing commercial and multi-family properties that are not owner occupied. 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.

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*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 of credit 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 and property value, 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 segment and class as of June 30, 2013, and December 31, 2012.

|                                   | Current    | Accruing            | Accruing             | Total          | Non-Accrual | Total Loans |
|-----------------------------------|------------|---------------------|----------------------|----------------|-------------|-------------|
|                                   |            | 30-89 Days Past Due | Greater than 90 days | Accruing Loans |             |             |
| <i>(In thousands)</i>             |            |                     |                      |                |             |             |
| <b>June 30, 2013:</b>             |            |                     |                      |                |             |             |
| Commercial and industrial         | \$ 55,644  | 329                 |                      | 55,973         | 57          | \$ 56,030   |
| Construction and land development | 44,285     |                     |                      | 44,285         | 1,601       | 45,886      |
| Commercial real estate:           |            |                     |                      |                |             |             |
| Owner occupied                    | 59,035     | 50                  |                      | 59,085         | 1,055       | 60,140      |
| Other                             | 115,274    | 1,448               |                      | 116,722        | 429         | 117,151     |
| Total commercial real estate      | 174,309    | 1,498               |                      | 175,807        | 1,484       | 177,291     |
| Residential real estate:          |            |                     |                      |                |             |             |
| Consumer mortgage                 | 53,742     | 325                 |                      | 54,067         | 1,125       | 55,192      |
| Investment property               | 43,258     | 176                 |                      | 43,434         | 395         | 43,829      |
| Total residential real estate     | 97,000     | 501                 |                      | 97,501         | 1,520       | 99,021      |
| Consumer installment              | 12,598     | 147                 |                      | 12,745         | 2           | 12,747      |
| Total                             | \$ 383,836 | 2,475               |                      | 386,311        | 4,664       | \$ 390,975  |
| <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  |





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### **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.

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 June 30, 2013 and December 31, 2012, and for the periods 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 quarter ended June 30, 2013, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 quarter historical period. In order to better capture the effect of current



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economic conditions on the Company's loan loss experience, the Company calculated average losses for all loan segments (except for the commercial real estate loan segment) using a rolling 8 quarter historical period for the quarter ended June 30, 2013. Based upon management's review of charge-off trends for each loan segment, the Company continued to calculate average losses for the commercial real estate loan segment using a rolling 6 quarter historical period for the quarter ended June 30, 2013. If the Company continued to calculate average losses for all loan segments using a rolling 6 quarter historical period, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$1.1 million at June 30, 2013. Other than the changes discussed above, the Company has not made any changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

The following table details the changes in the allowance for loan losses by portfolio segment for the respective periods.

|                              |                       |                    |                    |                    |                    | <b>June 30, 2013</b> |         |
|------------------------------|-----------------------|--------------------|--------------------|--------------------|--------------------|----------------------|---------|
|                              | <b>Construction</b>   |                    |                    | <b>Residential</b> |                    |                      |         |
|                              | <b>Commercial and</b> | <b>and land</b>    | <b>Commercial</b>  |                    | <b>Consumer</b>    |                      |         |
| <i>(In thousands)</i>        | <b>Commercial and</b> | <b>development</b> | <b>real estate</b> | <b>real</b>        | <b>installment</b> | <b>Total</b>         |         |
|                              | <b>industrial</b>     |                    |                    | <b>estate</b>      |                    |                      |         |
| <b>Quarter ended:</b>        |                       |                    |                    |                    |                    |                      |         |
| Beginning balance            | \$ 569                | 1,619              | 3,571              | 885                | 125                | \$                   | 6,769   |
| Charge-offs                  |                       |                    | (118)              | (189)              | (45)               |                      | (352)   |
| Recoveries                   | 5                     | 2                  |                    | 28                 | 5                  |                      | 40      |
| Net (charge-offs) recoveries | 5                     | 2                  | (118)              | (161)              | (40)               |                      | (312)   |
| Provision                    | 101                   | (167)              | (342)              | 401                | 7                  |                      |         |
| Ending balance               | \$ 675                | 1,454              | 3,111              | 1,125              | 92                 | \$                   | 6,457   |
| <b>Six months ended:</b>     |                       |                    |                    |                    |                    |                      |         |
| Beginning balance            | \$ 812                | 1,545              | 3,137              | 1,126              | 103                | \$                   | 6,723   |
| Charge-offs                  | (68)                  | (39)               | (118)              | (455)              | (62)               |                      | (742)   |
| Recoveries                   | 17                    | 3                  | 4                  | 41                 | 11                 |                      | 76      |
| Net charge-offs              | (51)                  | (36)               | (114)              | (414)              | (51)               |                      | (666)   |
| Provision                    | (86)                  | (55)               | 88                 | 413                | 40                 |                      | 400     |
| Ending balance               | \$ 675                | 1,454              | 3,111              | 1,125              | 92                 | \$                   | 6,457   |
|                              |                       |                    |                    |                    |                    | <b>June 30, 2012</b> |         |
|                              | <b>Construction</b>   |                    |                    | <b>Residential</b> |                    |                      |         |
|                              | <b>Commercial</b>     | <b>and land</b>    | <b>Commercial</b>  |                    | <b>Consumer</b>    |                      |         |
| <i>(In thousands)</i>        | <b>and</b>            | <b>development</b> | <b>real estate</b> | <b>real</b>        | <b>installment</b> | <b>Total</b>         |         |
|                              | <b>industrial</b>     |                    |                    | <b>estate</b>      |                    |                      |         |
| <b>Quarter ended:</b>        |                       |                    |                    |                    |                    |                      |         |
| Beginning balance            | \$ 845                | 1,439              | 3,816              | 1,332              | 64                 |                      | 7,496   |
| Charge-offs                  | (95)                  | (231)              | (1,218)            | (78)               | (26)               | \$                   | (1,648) |
| Recoveries                   | 5                     | 1                  |                    | 45                 | 4                  | \$                   | 55      |
| Net charge-offs              | (90)                  | (230)              | (1,218)            | (33)               | (22)               |                      | (1,593) |
| Provision                    | (24)                  | 414                | 219                | (21)               | 12                 | \$                   | 600     |
| Ending balance               | \$ 731                | 1,623              | 2,817              | 1,278              | 54                 | \$                   | 6,503   |

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**Six months ended:**

|                   |        |       |         |       |      |          |
|-------------------|--------|-------|---------|-------|------|----------|
| Beginning balance | \$ 948 | 1,470 | 3,009   | 1,363 | 129  | \$ 6,919 |
| Charge-offs       | (95)   | (231) | (1,218) | (111) | (32) | (1,687)  |
| Recoveries        | 8      | 1     |         | 51    | 11   | 71       |
| Net charge-offs   | (87)   | (230) | (1,218) | (60)  | (21) | (1,616)  |
| Provision         | (130)  | 383   | 1,026   | (25)  | (54) | 1,200    |
| Ending balance    | \$ 731 | 1,623 | 2,817   | 1,278 | 54   | \$ 6,503 |

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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 June 30, 2013 and 2012.

|                                   | Collectively evaluated (1) |                           | Individually evaluated (2) |                           | Total                 |                           |
|-----------------------------------|----------------------------|---------------------------|----------------------------|---------------------------|-----------------------|---------------------------|
|                                   | Allowance                  | Recorded                  | Allowance                  | Recorded                  | Allowance             | Recorded                  |
|                                   | for<br>loan<br>losses      | investment<br>in<br>loans | for<br>loan<br>losses      | investment<br>in<br>loans | for<br>loan<br>losses | investment<br>in<br>loans |
| <i>(In thousands)</i>             |                            |                           |                            |                           |                       |                           |
| <b>June 30, 2013:</b>             |                            |                           |                            |                           |                       |                           |
| Commercial and industrial         | \$ 675                     | 55,882                    |                            | 148                       | 675                   | 56,030                    |
| Construction and land development | 1,347                      | 44,285                    | 107                        | 1,601                     | 1,454                 | 45,886                    |
| Commercial real estate            | 2,991                      | 174,922                   | 120                        | 2,369                     | 3,111                 | 177,291                   |
| Residential real estate           | 1,069                      | 97,732                    | 56                         | 1,289                     | 1,125                 | 99,021                    |
| Consumer installment              | 92                         | 12,747                    |                            |                           | 92                    | 12,747                    |
| <b>Total</b>                      | <b>\$ 6,174</b>            | <b>385,568</b>            | <b>283</b>                 | <b>5,407</b>              | <b>6,457</b>          | <b>390,975</b>            |
| <b>June 30, 2012:</b>             |                            |                           |                            |                           |                       |                           |
| Commercial and industrial         | \$ 731                     | 59,223                    |                            | 195                       | 731                   | 59,418                    |
| Construction and land development | 1,257                      | 35,110                    | 366                        | 3,858                     | 1,623                 | 38,968                    |
| Commercial real estate            | 2,666                      | 182,817                   | 151                        | 3,029                     | 2,817                 | 185,846                   |
| Residential real estate           | 953                        | 102,678                   | 325                        | 1,549                     | 1,278                 | 104,227                   |
| Consumer installment              | 54                         | 11,133                    |                            |                           | 54                    | 11,133                    |
| <b>Total</b>                      | <b>\$ 5,661</b>            | <b>390,961</b>            | <b>842</b>                 | <b>8,631</b>              | <b>6,503</b>          | <b>399,592</b>            |

- (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.

**Table of Contents****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 qualitative and environmental factors 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.

|                                   |             | <b>Special</b> | <b>Substandard</b> |                   |                    |
|-----------------------------------|-------------|----------------|--------------------|-------------------|--------------------|
|                                   | <b>Pass</b> | <b>Mention</b> | <b>Accruing</b>    | <b>Nonaccrual</b> | <b>Total loans</b> |
| <i>(In thousands)</i>             |             |                |                    |                   |                    |
| <b>June 30, 2013:</b>             |             |                |                    |                   |                    |
| Commercial and industrial         | \$ 55,087   | 2              | 884                | 57                | \$ 56,030          |
| Construction and land development | 42,710      | 374            | 1,201              | 1,601             | 45,886             |
| Commercial real estate:           |             |                |                    |                   |                    |
| Owner occupied                    | 56,834      | 760            | 1,491              | 1,055             | 60,140             |
| Other                             | 113,552     | 2,828          | 342                | 429               | 117,151            |
| Total commercial real estate      | 170,386     | 3,588          | 1,833              | 1,484             | 177,291            |
| Residential real estate:          |             |                |                    |                   |                    |
| Consumer mortgage                 | 47,619      | 793            | 5,655              | 1,125             | 55,192             |
| Investment property               | 40,384      | 933            | 2,117              | 395               | 43,829             |
| Total residential real estate     | 88,003      | 1,726          | 7,772              | 1,520             | 99,021             |
| Consumer installment              | 12,579      | 20             | 146                | 2                 | 12,747             |
| Total                             | \$ 368,765  | 5,710          | 11,836             | 4,664             | \$ 390,975         |
| <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             |

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|       |    |         |       |        |        |            |
|-------|----|---------|-------|--------|--------|------------|
| Total | \$ | 368,837 | 6,447 | 12,607 | 10,535 | \$ 398,426 |
|-------|----|---------|-------|--------|--------|------------|



**Table of Contents****Impaired loans**

The following tables present 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 installment loans).

The following tables set forth certain information regarding the Company's impaired loans that were individually evaluated for impairment at June 30, 2013 and December 31, 2012.

|                                    | June 30, 2013                      |   |                            | Related allowance |
|------------------------------------|------------------------------------|---|----------------------------|-------------------|
|                                    | Unpaid principal<br>balance<br>(1) | Charge-offs and<br>payments applied (2) | Recorded<br>investment (3) |                   |
| <i>(In thousands)</i>              |                                    |   |                            |                   |
| <b>With no allowance recorded:</b> |                                    |   |                            |                   |
| Commercial and industrial          | \$ 148                             |   | 148                        |                   |
| Construction and land development  | 2,878                              | (1,681)                                 | 1,197                      |                   |
| Commercial real estate:            |                                    |   |                            |                   |
| Owner occupied                     | 350                                | (51)                                    | 299                        |                   |
| Other                              | 515                                | (86)                                    | 429                        |                   |
| Total commercial real estate       | 865                                | (137)                                   | 728                        |                   |
| Residential real estate:           |                                    |   |                            |                   |
| Consumer mortgages                 | 960                                | (177)                                   | 783                        |                   |
| Investment property                | 210                                | (29)                                    | 181                        |                   |
| Total residential real estate      | 1,170                              | (206)                                   | 964                        |                   |
| <b>Total</b>                       | <b>\$ 5,061</b>                    | <b>(2,024)</b>                          | <b>3,037</b>               |                   |
| <b>With allowance recorded:</b>    |                                    |   |                            |                   |
| Construction and land development  | \$ 461                             | (57)                                    | 404                        | \$ 107            |
| Commercial real estate:            |                                    |   |                            |                   |
| Owner occupied                     | 1,759                              | (118)                                   | 1,641                      | 120               |
| Total commercial real estate       | 1,759                              | (118)                                   | 1,641                      | 120               |
| Residential real estate:           |                                    |   |                            |                   |
| Investment property                | 412                                | (87)                                    | 325                        | 56                |
| Total residential real estate      | 412                                | (87)                                    | 325                        | 56                |
| <b>Total</b>                       | <b>\$ 2,632</b>                    | <b>(262)</b>                            | <b>2,370</b>               | <b>\$ 283</b>     |
| <b>Total impaired loans</b>        | <b>\$ 7,693</b>                    | <b>(2,286)</b>                          | <b>5,407</b>               | <b>\$ 283</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 subsequent to the loans being placed on nonaccrual status.
- (3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

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| <i>(In thousands)</i>              | December 31, 2012            |                                      |                         | Related allowance |
|------------------------------------|------------------------------|--------------------------------------|-------------------------|-------------------|
|                                    | Unpaid principal balance (1) | Charge-offs and payments applied (2) | Recorded investment (3) |                   |
| <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                   |                   |
| <b>Total</b>                       | <b>\$ 13,228</b>             | <b>(4,018)</b>                       | <b>9,210</b>            |                   |
| <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               |
| <b>Total</b>                       | <b>\$ 1,370</b>              | <b>(45)</b>                          | <b>1,325</b>            | <b>\$ 263</b>     |
| <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 subsequent to the loans being placed on nonaccrual status.
- (3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

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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 during the respective periods.

| <i>(In thousands)</i>             | Quarter ended June 30, 2013<br>Average<br>recorded<br>investment | Total interest<br>income<br>recognized | Six months ended June 30, 2013<br>Average<br>recorded<br>investment | Total interest<br>income<br>recognized |
|-----------------------------------|--|--|---|--|
| <b>Impaired loans:</b>            |  |  |   |  |
| Commercial and industrial         | \$ 150   | 2                                      | 158   | 5                                      |
| Construction and land development | 1,607  |  | 1,614   |  |
| Commercial real estate:           |  |  |   |  |
| Owner occupied                    | 1,984  | 14                                     | 2,019   | 29                                     |
| Other                             | 430  |  | 1,902   |  |
| Total commercial real estate      | 2,414  | 14                                     | 3,921   | 29                                     |
| Residential real estate:          |  |  |   |  |
| Consumer mortgages                | 789  |  | 801   |  |
| Investment property               | 348  |  | 323   |  |
| Total residential real estate     | 1,137  |  | 1,124   |  |
| <b>Total</b>                      | <b>\$ 5,308</b>  | <b>16</b>                              | <b>6,817</b>  | <b>34</b>                              |

| <i>(In thousands)</i>             | Quarter ended June 30, 2012<br>Average<br>recorded<br>investment | Total interest<br>income<br>recognized | Six months ended June 30, 2012<br>Average<br>recorded<br>investment | Total interest<br>income<br>recognized |
|-----------------------------------|--|--|---|--|
| <b>Impaired loans:</b>            |  |  |   |  |
| Commercial and industrial         | \$ 197   | 4                                      | 205   | 8                                      |
| Construction and land development | 4,185  |  | 4,595   |  |
| Commercial real estate:           |  |  |   |  |
| Owner occupied                    | 2,561  | 18                                     | 2,566   | 35                                     |
| Other                             | 1,245  |  | 1,500   |  |
| Total commercial real estate      | 3,806  | 18                                     | 4,066   | 35                                     |
| Residential real estate:          |  |  |   |  |
| Consumer mortgages                | 863  |  | 881   |  |
| Investment property               | 695  |  | 562   |  |
| Total residential real estate     | 1,558  |  | 1,443   |  |
| <b>Total</b>                      | <b>\$ 9,746</b>  | <b>22</b>                              | <b>10,309</b>   | <b>43</b>                              |

**Troubled Debt Restructurings**

Impaired loans also include troubled debt restructurings ( TDRs ). In the normal course of business, management may grant concessions to borrowers that are experiencing financial difficulty. A concession may include, but is not limited to, delays in required payments of principal and interest for a specified period, 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 restructure.

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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, including those that have payment defaults, for possible impairment.

The following is a summary of accruing and nonaccrual TDRs, which are included in impaired loan totals, and the related allowance for loan losses, by portfolio segment and class as of June 30, 2013, and December 31, 2012.

| <i>(In thousands)</i>             | TDRs            |              |              | Related<br>Allowance |
|-----------------------------------|-----------------|--------------|--------------|----------------------|
|                                   | Accruing        | Nonaccrual   | Total        |                      |
| <b>June 30, 2013</b>              |                 |              |              |                      |
| Commercial and industrial         | \$ 148          |              | 148          | \$                   |
| Construction and land development |                 | 1,601        | 1,601        | 107                  |
| Commercial real estate:           |                 |              |              |                      |
| Owner occupied                    | 885             | 299          | 1,184        | 120                  |
| Other                             |                 | 429          | 429          |                      |
| Total commercial real estate      | 885             | 728          | 1,613        | 120                  |
| Residential real estate:          |                 |              |              |                      |
| Consumer mortgages                |                 | 783          | 783          |                      |
| Investment property               |                 | 225          | 225          |                      |
| Total residential real estate     |                 | 1,008        | 1,008        |                      |
| <b>Total</b>                      | <b>\$ 1,033</b> | <b>3,337</b> | <b>4,370</b> | <b>\$ 227</b>        |
| <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        |                      |
| <b>Total</b>                      | <b>\$ 1,068</b> | <b>4,107</b> | <b>5,175</b> | <b>\$ 263</b>        |

At June 30, 2013, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

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

|                                   | Quarter ended June 30, |  |   | Six Months ended June 30, |  |   |
|-----------------------------------|------------------------|--|---|---------------------------|--|---|
|                                   | 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 |
| <i>(Dollars in thousands)</i>     |                        |  |   |                           |  |   |
| <b>2013:</b>                      |                        |  |   |                           |  |   |
| Commercial real estate:           |                        |  |   |                           |  |   |
| Other                             |                        | \$   |   | 1                         | \$ 431   | 431   |
| Total commercial real estate      |                        |  |   | 1                         | 431  | 431   |
| Residential real estate:          |                        |  |   |                           |  |   |
| Consumer mortgages                |                        |  |   | 1                         | 131  | 131   |
| Total residential real estate     |                        |  |   | 1                         | 131  | 131   |
| Total                             |                        | \$   |   | 2                         | \$ 562   | 562   |
| <b>2012:</b>                      |                        |  |   |                           |  |   |
| Construction and land development |                        | \$   |   | 2                         | \$ 2,842   | 1,753   |
| Commercial real estate:           |                        |  |   |                           |  |   |
| Owner occupied                    | 3                      | 2,349  | 1,406   | 4                         | 3,167  | 2,225   |
| Other                             |                        |  |   | 2                         | 1,804  | 1,657   |
| Total commercial real estate      | 3                      | 2,349  | 1,406   | 6                         | 4,971  | 3,882   |
| Residential real estate:          |                        |  |   |                           |  |   |
| Consumer mortgages                | 2                      | 863  | 857   | 2                         | 863  | 857   |
| Total residential real estate     | 2                      | 863  | 857   | 2                         | 863  | 857   |
| Total                             | 5                      | \$ 3,212   | 2,263   | 10                        | \$ 8,676   | 6,492   |

The majority of the loans modified in a TDR during the quarters and six months ended June 30, 2013 and 2012, respectively, included permitting 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 considered to be less than a market rate.

For the quarter ended June 30, 2012, the decrease in the post modification outstanding recorded investment was primarily due to A/B note restructurings, where the B note was charged off. Total charge-offs related to B notes were \$0.9 million for the quarter ended June 30, 2012.

For the six months ended June 30, 2012, the decrease in the post modification outstanding recorded investment was 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. Total charge-offs related to B notes were \$0.9 million for the six months ended June 30, 2012.

The following table summarizes the recorded investment in loans modified in a TDR within the previous 12 months for which there was a payment default (defined as 90 days or more past due) during the respective periods.

Quarter ended  
June 30,                      Six months ended June 30,

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(Dollars in thousands)

|                                   | Number of<br>Contracts | Recorded<br>investment <sup>(1)</sup> | Number of<br>Contracts | Recorded<br>investment <sup>(1)</sup> |
|-----------------------------------|------------------------|---------------------------------------|------------------------|---------------------------------------|
| <b>2013:</b>                      |                        |                                       |                        |                                       |
| Construction and land development |                        | \$                                    | 1                      | \$ 1,197                              |
| Total                             |                        | \$                                    | 1                      | \$ 1,197                              |
| <b>2012:</b>                      |                        |                                       |                        |                                       |
| Construction and land development |                        | \$                                    | 1                      | \$ 2,386                              |
| Total                             |                        | \$                                    | 1                      | \$ 2,386                              |

(1) Amount as of applicable month end during the respective period for which there was a payment default.



**Table of Contents****NOTE 6: 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 MSRs for impairment. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation allowance 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 MSRs and the related valuation allowance for the quarters and six months ended June 30, 2013 and 2012 are presented below.

| <i>(Dollars in thousands)</i>                     | <b>Quarters ended June 30,<br/>2013</b> | <b>2012</b> | <b>Six months ended June 30,<br/>2013</b> | <b>2012</b> |
|---|---|-------------|---|-------------|
| <b>MSRs, net:</b>                                 |   |             |   |             |
| Beginning balance                                 | \$ 1,728                                | \$ 1,260    | \$ 1,526                                  | \$ 1,245    |
| Additions, net                                    | 218                                     | 198         | 478                                       | 366         |
| Amortization expense                              | (102)                                   | (93)        | (226)                                     | (183)       |
| Change in valuation allowance                     | 135                                     | (46)        | 201                                       | (109)       |
| Ending balance                                    | \$ 1,979                                | \$ 1,319    | \$ 1,979                                  | \$ 1,319    |
| <b>Valuation allowance included in MSRs, net:</b> |   |             |   |             |
| Beginning of period                               | \$ 320                                  | \$ 180      | \$ 386                                    | \$ 117      |
| End of period                                     | 185                                     | 226         | 185                                       | 226         |
| <b>Fair value of amortized MSRs:</b>              |   |             |   |             |
| Beginning of period                               | \$ 1,994                                | \$ 1,260    | \$ 1,526                                  | \$ 1,245    |
| End of period                                     | 2,453                                   | 1,319       | 2,453                                     | 1,319       |

**NOTE 7: DERIVATIVE INSTRUMENTS**

Financial derivatives are reported at fair value in other assets or other liabilities on the accompanying Consolidated Balance Sheets. 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 within other noninterest income on the accompanying Consolidated Statements of 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 swaps, 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 June 30, 2013, the Company had no derivative contracts designated as part of a hedging relationship to assist in managing its interest rate sensitivity.

Interest rate swap agreements involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument 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 is negative, the Company owes the customer or counterparty and therefore, has no credit risk.



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A summary of the Company's interest rate swap agreements at June 30, 2013 and December 31, 2012 is presented below.

|                                     | Notional  | Other Assets<br>Estimated<br>Fair Value | Other Liabilities<br>Estimated<br>Fair Value |
|-------------------------------------|-----------|---|--|
| <i>(Dollars in thousands)</i>       |           |   |  |
| <b>June 30, 2013:</b>               |           |   |  |
| Pay fixed / receive variable        | \$ 5,221  |   | 961  |
| Pay variable / receive fixed        | 5,221     | 961                                     |  |
| Total interest rate swap agreements | \$ 10,442 | 961                                     | 961  |
| <b>December 31, 2012:</b>           |           |   |  |
| Pay fixed / receive variable        | \$ 5,367  |   | 1,210  |
| Pay variable / receive fixed        | 5,367     | 1,210                                   |  |
| Total interest rate swap agreements | \$ 10,734 | 1,210                                   | 1,210  |

**NOTE 8: 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 six months ended June 30, 2013, there were no transfers between levels and no changes in valuation techniques for the Company's financial assets and liabilities.

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### **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.

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The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012, respectively, by caption, on the accompanying Consolidated Balance Sheets by ASC 820 valuation hierarchy (as described above).

|  | Amount            | Quoted Prices in Active Markets |   |   |
|--|-------------------|---------------------------------|---|---|
|  |                   | for Identical Assets (Level 1)  | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <i>(Dollars in thousands)</i>              |                   |                                 |   |   |
| <b>June 30, 2013:</b>                      |                   |                                 |   |   |
| Securities available-for-sale:             |                   |                                 |   |   |
| Agency obligations                         | \$ 46,615         |                                 | 46,615  |   |
| Agency RMBS                                | 153,963           |                                 | 153,963                                       |   |
| State and political subdivisions           | 69,522            |                                 | 69,522  |   |
| Trust preferred securities                 | 694               |                                 |   | 694                                       |
| <b>Total securities available-for-sale</b> | <b>270,794</b>    |                                 | <b>270,100</b>                                | <b>694</b>                                |
| Other assets <sup>(1)</sup>                | 961               |                                 | 961   |   |
| <b>Total assets at fair value</b>          | <b>\$ 271,755</b> |                                 | <b>271,061</b>                                | <b>694</b>                                |
| Other liabilities <sup>(1)</sup>           | 961               |                                 | 961   |   |
| <b>Total liabilities at fair value</b>     | <b>\$ 961</b>     |                                 | <b>961</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                                       |
| <b>Total securities available-for-sale</b> | <b>259,475</b>    |                                 | <b>258,823</b>                                | <b>652</b>                                |
| Other assets <sup>(1)</sup>                | 1,210             |                                 | 1,210   |   |
| <b>Total assets at fair value</b>          | <b>\$ 260,685</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>1,210</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*

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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 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.

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

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of June 30, 2013 and December 31, 2012, respectively, by caption, on the accompanying Consolidated Balance Sheets and by FASB ASC 820 valuation hierarchy (as described above):

| <i>(Dollars in thousands)</i> | Amount    | Quoted Prices in<br>Active Markets<br>for<br>Identical Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------|-----------|--|--|--|
| <b>June 30, 2013:</b>         |           |  |  |  |
| Loans held for sale           | \$ 4,824  |  | 4,824                                      |  |
| Loans, net <sup>(1)</sup>     | 5,124     |  |  | 5,124  |
| Other real estate owned       | 3,609     |  |  | 3,609  |
| Other assets <sup>(2)</sup>   | 1,979     |  |  | 1,979  |
| Total assets at fair value    | \$ 15,536 |  | 4,824                                      | 10,712   |
| <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  |

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|                            |    |        |       |        |
|----------------------------|----|--------|-------|--------|
| Total assets at fair value | \$ | 19,604 | 2,887 | 16,717 |
|----------------------------|----|--------|-------|--------|

- (1) Loans considered impaired under ASC 310-10-35 Receivables. This amount reflects the recorded investment in impaired loans, net of any related allowance for loan losses.
- (2) Represents the carrying value of MSRs, net.



**Table of Contents****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:

| <i>(Dollars in thousands)</i>                     | Six months ended June 30, |          |
|---|---------------------------|----------|
|   | 2013                      | 2012     |
| Beginning balance                                 | \$ 652                    | \$ 1,986 |
| Total realized and unrealized gains and (losses): |                           |          |
| Included in net earnings                          |                           | (6)      |
| Included in other comprehensive income            | 42                        | 124      |
| Sales   |                           | (974)    |
| Settlements                                       |                           | (500)    |
| Ending balance                                    | \$ 694                    | \$ 630   |

For Level 3 assets measured at fair value on a recurring or non-recurring basis as of June 30, 2013, 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     | \$ 694          | Discounted cash flow | Credit spread (basis points)   | 624 bp                    |
| <b>Nonrecurring:</b>           |                 |                      |                                |                           |
| Impaired loans                 | \$ 5,124        | Appraisal            | Appraisal discounts (%)        | 13.9 %                    |
| Other real estate owned        | 3,609           | Appraisal            | Appraisal discounts (%)        | 9.2 %                     |
| Mortgage servicing rights, net | 1,979           | Discounted cash flow | Prepayment speed or CPR (%)    | 12.0 %                    |
|                                |                 |                      | Discount rate (%)              | 11.0 %                    |

**Fair Value of Financial Instruments**

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. 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 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.

**Table of Contents****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 June 30, 2013 and December 31, 2012 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. In addition, financial liabilities for which fair value approximates carrying value included overnight borrowings such as federal funds purchased and securities sold under agreements to repurchase.

| <i>(Dollars in thousands)</i> | Carrying<br>amount | Estimated<br>fair value | Fair Value Hierarchy |                   |                   |
|-------------------------------|--------------------|-------------------------|----------------------|-------------------|-------------------|
|                               |                    |                         | Level 1<br>inputs    | Level 2<br>inputs | Level 3<br>Inputs |
| <b>June 30, 2013:</b>         |                    |                         |                      |                   |                   |
| Financial Assets:             |                    |                         |                      |                   |                   |
| Loans, net (1)                | \$ 384,269         | \$ 393,855              | \$                   | \$                | \$ 393,855        |
| Financial Liabilities:        |                    |                         |                      |                   |                   |
| Time Deposits                 | \$ 261,825         | \$ 265,782              | \$                   | \$ 265,782        | \$                |
| Long-term debt                | 27,217             | 29,324                  |                      | 29,324            |                   |
| <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            |                   |

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

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### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

#### **General**

The following discussion and analysis is designed to provide a better understanding of various factors related to the results of operations and financial condition of the Auburn National Bancorporation, Inc. (the Company) and its wholly owned subsidiary, AuburnBank (the Bank). This discussion is intended to supplement and highlight information contained in the accompanying unaudited condensed consolidated financial statements and related notes for the quarter and six month periods ended June 30, 2013 and 2012, as well as the information contained in our annual report on Form 10-K for the year ended December 31, 2012 and our quarterly report on Form 10-Q for the quarter ended March 31, 2013.

#### **Special Notice Regarding Forward-Looking Statements**

Certain of the statements made in this discussion and analysis and elsewhere, including information incorporated herein by reference to other documents, are forward-looking statements within the meaning of, and subject to, the protections of Section 27A of the Securities Act of 1933, as amended, (the Securities Act) 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, continue, expect, estimate, continue, further, plan, point to, project, could, intend, target and other similar words and expressions of the forward-looking statements may not be realized due to a variety of factors, including, without limitation:

the effects of future economic, business and market conditions and changes, domestic and foreign, including seasonality;

governmental monetary and fiscal policies;

legislative and regulatory changes, including changes in banking, securities and tax laws, regulations and rules and their application by our regulators, including capital and liquidity requirements, and changes in the scope and cost of FDIC insurance and other coverage;

changes in accounting policies, rules and practices;

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;

changes in borrower credit risks and payment behaviors;

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;

changes in the prices, values and sales volumes of residential and commercial real estate;

the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;

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the failure of assumptions and estimates underlying the establishment of reserves for possible loan losses and other estimates;

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;

changes in technology or products that may be more difficult, costly, or less effective than anticipated;

the effects of war or other conflicts, acts of terrorism or other catastrophic events that may affect general economic conditions;

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;

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

the other factors and information in this report and other filings that we make with the SEC under the Exchange Act, including our annual report on Form 10-K for the year ended December 31, 2012 and subsequent quarterly and current reports. See Part II, Item 1A, RISK FACTORS.

All written or oral forward-looking statements that are made by or 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.

**Business**

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, Valley, Hurtsboro, and Notasulga, Alabama. In-store branches are located in the Auburn and Opelika Kroger stores, as well as Wal-Mart SuperCenter stores in Auburn and Opelika. Loan production offices are located in Montgomery and Phenix City, Alabama.

**Summary of Results of Operations**

|   | Quarter ended June 30, |          | Six months ended June 30, |           |
|---|------------------------|----------|---------------------------|-----------|
|   | 2013                   | 2012     | 2013                      | 2012      |
| <i>(Dollars in thousands, except per share amounts)</i> |                        |          |                           |           |
| Net interest income (a)                                 | \$ 5,597               | \$ 5,728 | \$ 11,120                 | \$ 11,143 |
| Less: tax-equivalent adjustment                         | 365                    | 416      | 747                       | 830       |
| Net interest income (GAAP)                              | 5,232                  | 5,312    | 10,373                    | 10,313    |
| Noninterest income                                      | 2,071                  | 1,814    | 3,726                     | 6,678     |
| Total revenue   | 7,303                  | 7,126    | 14,099                    | 16,991    |

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|                                      |                 |                 |                 |                 |
|--------------------------------------|-----------------|-----------------|-----------------|-----------------|
| Provision for loan losses            |                 | 600             | 400             | 1,200           |
| Noninterest expense                  | 4,724           | 4,048           | 8,950           | 11,590          |
| Income tax expense                   | 672             | 449             | 1,153           | 707             |
| <b>Net earnings</b>                  | <b>\$ 1,907</b> | <b>\$ 2,029</b> | <b>\$ 3,596</b> | <b>\$ 3,494</b> |
| Basic and diluted earnings per share | \$ 0.52         | \$ 0.56         | \$ 0.99         | \$ 0.96         |

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

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### **Financial Summary**

The Company's net earnings were \$3.6 million for the first six months of 2013, compared to \$3.5 million for the first six months of 2012. Basic and diluted earnings per share were \$0.99 per share for the first six months of 2013, compared to \$0.96 per share for the first six months of 2012.

Net interest income (tax-equivalent) was \$11.1 million for the first six months of 2013 and 2012. Despite downward pressure on yields for earning assets, net interest income (tax-equivalent) was largely unchanged due to continued improvement in the Company's cost of funds. Average loans were \$392.9 million in the first six months of 2013, an increase of \$6.7 million, or 2%, from the first six months of 2012. Average deposits were \$653.4 million in the first six months of 2013, an increase of \$19.0 million, or 3%, from the first six months of 2012.

The provision for loan losses was \$0.4 million and \$1.2 million for the first six months of 2013 and 2012, respectively. The Company's annualized net charge-off ratio was 0.34% in the first six months of 2013, compared to 0.84% in the first six months of 2012. The decrease in the provision for loan losses was primarily due to a decline in net charge-offs and an improvement in the overall credit quality of the loan portfolio, including lower levels of adversely classified and nonperforming loans.

Noninterest income was \$3.7 million for the first six months of 2013, compared to \$6.7 million in the first six months of 2012. The decrease was primarily due to a non-recurring gain of \$3.3 million realized in the first six months of 2012 when the Company sold its interests in three affordable housing limited partnerships.

Noninterest expense was approximately \$9.0 million in the first six months of 2013 compared to \$11.6 million in the second quarter of 2012. The decrease was primarily due to a decrease in prepayment penalties on long-term debt. During the first six months of 2013, the Company repaid \$20.0 million of FHLB advances with a weighted average interest rate of 3.38% and incurred prepayment penalties of \$1.5 million. During the first six months of 2012, the Company repaid \$38.0 million of FHLB advances with a weighted average interest rate of 4.26% and incurred prepayment penalties of \$3.7 million.

Income tax expense was approximately \$1.2 million for the first six months of 2013, compared to \$0.7 million in the first six months of 2012. The Company's effective tax rate for the first six months of 2013 was 24.28%, compared to 16.83% in the first six months of 2012. The Company's effective tax rate increased during the first six months of 2013 when compared to the first six months of 2012 primarily due to an increase in the level of earnings before taxes and the Company's annualized effective tax rate for 2012 was reduced by the reversal of a deferred tax valuation allowance of \$0.5 million related to capital loss carry-forwards.

In the first six months of 2013, the Company paid cash dividends of \$1.5 million, or \$0.42 per share. The Company's balance sheet remains well capitalized under current regulatory guidelines with a total risk-based capital ratio of 17.70% and a Tier 1 leverage ratio of 9.76% at June 30, 2013.

### **CRITICAL ACCOUNTING POLICIES**

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles 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, the valuation of other real estate owned, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

Except as discussed below, there have been no material changes to the Company's critical accounting policies, estimates, and assumptions, or the judgments affecting the application of these estimates and assumptions in 2013.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. During the quarter ended June 30, 2013, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 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 for all loan segments (except for the commercial real estate loan segment) using a rolling 8 quarter historical period for the quarter ended June 30, 2013. Based upon management's review of charge-off trends for each loan segment, the Company continued to





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calculate average losses for the commercial real estate loan segment using a rolling 6 quarter historical period for the quarter ended June 30, 2013. If the Company continued to calculate average losses for all loan segments using a rolling 6 quarter historical period, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$1.1 million at June 30, 2013. Other than the changes discussed above, the Company has not made any changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

### **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.

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 June 30, 2013 and December 31, 2012, and for the periods 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.



**Table of Contents****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**

U.S. 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. ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 8, 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.

**Table of Contents****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 June 30, 2013. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

**RESULTS OF OPERATIONS****Average Balance Sheet and Interest Rates**

|   | Six months ended June 30, |            |                 |            |
|---|---------------------------|------------|-----------------|------------|
|   | 2013                      |            | 2012            |            |
| (Dollars in thousands)  | Average Balance           | Yield/Rate | Average Balance | Yield/Rate |
| Loans and loans held for sale   | \$ 396,498                | 5.37%      | \$ 388,398      | 5.57%      |
| Securities taxable  | 194,205                   | 1.84%      | 216,675         | 2.06%      |
| Securities tax-exempt   | 70,369                    | 6.30%      | 78,280          | 6.27%      |
| Total securities  | 264,574                   | 3.03%      | 294,955         | 3.18%      |
| Federal funds sold  | 55,881                    | 0.22%      | 18,195          | 0.23%      |
| Interest bearing bank deposits  | 892                       |            | 1,032           |            |
| Total interest-earning assets   | 717,845                   | 4.10%      | 702,580         | 4.42%      |
| Deposits:   |                           |            |                 |            |
| NOW   | 104,851                   | 0.32%      | 101,651         | 0.39%      |
| Savings and money market  | 168,263                   | 0.52%      | 154,029         | 0.59%      |
| Certificates of deposits less than \$100,000                          | 105,533                   | 1.42%      | 110,451         | 1.69%      |
| Certificates of deposits and other time deposits of \$100,000 or more | 154,745                   | 1.83%      | 163,437         | 2.16%      |
| Total interest-bearing deposits                                       | 533,392                   | 1.04%      | 529,568         | 1.26%      |
| Short-term borrowings   | 2,754                     | 0.51%      | 3,299           | 0.55%      |
| Long-term debt  | 39,095                    | 3.62%      | 51,033          | 3.76%      |
| Total interest-bearing liabilities                                    | 575,241                   | 1.21%      | 583,900         | 1.48%      |
| Net interest income and margin (tax-equivalent)                       | \$ 11,120                 | 3.12%      | \$ 11,143       | 3.19%      |

**Net Interest Income and Margin**

Net interest income (tax-equivalent) was \$11.1 million in the first six months of 2013 and 2012, as continued improvement in the Company's funding mix and cost of funds largely offset declining yields on earning assets. Although net interest income was unchanged, management continues to seek to increase earnings by growing the Company's loan portfolio (in total and as a percentage of our earning assets), focusing on deposit pricing, and repaying higher-cost wholesale funding sources. These efforts to increase earnings were offset by management's decision to reduce its securities portfolio as a percentage of total interest earning assets and carry higher levels of short-term interest earning assets (e.g. federal funds sold). As a result, the Company's net interest margin (tax-equivalent) declined to 3.12% in the first six months of 2013, compared to 3.19% for the first six months of 2012.

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The tax-equivalent yield on total interest-earning assets decreased by 32 basis points in the first six months of 2013 from the first six months of 2012 to 4.10%. The decrease was primarily due to the shift in our asset mix described above, lower reinvestment yields in the securities portfolio, and increased pricing competition for quality loan opportunities in our markets, which has limited the Company's ability to increase yields on new and renewed loans over the last several quarters.

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The cost of total interest-bearing liabilities decreased 27 basis points in the first six months of 2013 from the first six months of 2012 to 1.21%. The net decrease was largely a 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 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 reduce our cost of funds due to the low level of deposit rates currently.

**Provision for Loan Losses**

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that management believes, based on its processes and estimates, should be adequate to provide for the probable losses on outstanding loans. The provisions for loan losses amounted to \$0.4 million and \$1.2 million for the six months ended June 30, 2013 and 2012, respectively. The decrease in the provision for loan losses was primarily due to a decline in net charge-offs and improvement in the overall credit quality of the loan portfolio, including lower levels of adversely classified and nonperforming 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 its estimate of probable losses in the loan portfolio. The Company's allowance for loan losses as a percentage of total loans was 1.65% at June 30, 2013, compared to 1.69% at December 31, 2012. While the policies and procedures used to estimate the allowance for loan losses, as well as the resulting provision for loan losses charged to operations, are considered adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgments and are therefore approximate and imprecise. Factors beyond our control (such as conditions in the local and national economy, local real estate markets, or industry conditions) may have a material adverse effect on our asset quality and the adequacy of our allowance for loan losses resulting in significant increases in the provision for loan losses.

**Noninterest Income**

| <i>(Dollars in thousands)</i>                  | <b>Quarter ended June 30,</b> |                 | <b>Six months ended June 30,</b> |                 |
|--|-------------------------------|-----------------|----------------------------------|-----------------|
|  | <b>2013</b>                   | <b>2012</b>     | <b>2013</b>                      | <b>2012</b>     |
| Service charges on deposit accounts            | \$ 234                        | \$ 279          | \$ 483                           | \$ 570          |
| Mortgage lending income                        | 837                           | 785             | 1,647                            | 1,454           |
| Bank-owned life insurance                      | 101                           | 113             | 196                              | 212             |
| Gain on sale of affordable housing investments |                               |                 |                                  | 3,268           |
| Securities gains, net                          | 518                           | 251             | 679                              | 430             |
| Other  | 381                           | 386             | 721                              | 744             |
| <b>Total noninterest income</b>                | <b>\$ 2,071</b>               | <b>\$ 1,814</b> | <b>\$ 3,726</b>                  | <b>\$ 6,678</b> |

Service charges on deposit accounts decreased primarily due to a decline in insufficient funds charges, reflecting changes in customer behavior and spending patterns.

The Company's income from mortgage lending was 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.



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The following table presents a breakdown of the Company's mortgage lending income.

| <i>(Dollars in thousands)</i>                  | <b>Quarter ended June 30,</b> |               | <b>Six months ended June 30,</b> |                 |
|--|-------------------------------|---------------|----------------------------------|-----------------|
|  | <b>2013</b>                   | <b>2012</b>   | <b>2013</b>                      | <b>2012</b>     |
| Origination income                             | \$ 591                        | \$ 756        | \$ 1,258                         | \$ 1,416        |
| Servicing fees, net                            | 111                           | 75            | 188                              | 147             |
| Decrease (increase) in MSR valuation allowance | 135                           | (46)          | 201                              | (109)           |
| <b>Total mortgage lending income</b>           | <b>\$ 837</b>                 | <b>\$ 785</b> | <b>\$ 1,647</b>                  | <b>\$ 1,454</b> |

Mortgage lending income was \$1.6 million for the first six months of 2013, compared to \$1.5 million for the first six months of 2012. The increase in mortgage lending income was primarily due to a decrease in the valuation allowance for amortized MSRs, which was partially offset by a decline in origination income as refinance activity slowed. Changes in the valuation allowance for amortized MSRs are recognized in earnings as a component of mortgage lending income. The decrease in the valuation allowance was primarily due to a slowing of prepayment speeds, which increased the value of our amortized MSRs.

Mortgage lending income increased in the second quarter of 2013 when compared to the second quarter of 2012 due to the same factors described above.

The Company realized a gain on sale of \$3.3 million during the first six months of 2012 related to the sale of its interests in three affordable housing limited partnerships in January 2012. There were no such transactions in 2013.

Net securities gains consist of realized gains and losses on the sale of securities and other-than-temporary impairment charges. Net gains on the sale of securities were \$679,000 for the first six months of 2013, compared to net gains on the sale of securities of \$560,000 for the first six months of 2012. The Company incurred no other-than-temporary impairment charges for the first six months of 2013, compared to \$130,000 for the first six months of 2012, which related to trust preferred securities.

Net gains on the sale of securities were \$518,000 for the second quarter of 2013, compared to net gains on the sale of securities of \$251,000 for the second quarter of 2012. The Company incurred no other-than-temporary impairment charges for the second quarter of 2013 and 2012.

**Noninterest Expense**

| <i>(Dollars in thousands)</i>         | <b>Quarter ended June 30,</b> |                 | <b>Six months ended June 30,</b> |                  |
|---------------------------------------|-------------------------------|-----------------|----------------------------------|------------------|
|                                       | <b>2013</b>                   | <b>2012</b>     | <b>2013</b>                      | <b>2012</b>      |
| Salaries and benefits                 | \$ 2,114                      | \$ 2,205        | \$ 4,364                         | \$ 4,348         |
| Net occupancy and equipment           | 333                           | 336             | 664                              | 674              |
| Professional fees                     | 209                           | 188             | 385                              | 375              |
| FDIC and other regulatory assessments | 143                           | 185             | 337                              | 368              |
| Other real estate owned, net          | 20                            | (6)             | 43                               | 63               |
| Prepayment penalty on long-term debt  | 1046                          | 12              | 1,471                            | 3,720            |
| Other                                 | 859                           | 1,128           | 1,686                            | 2,042            |
| <b>Total noninterest expense</b>      | <b>\$ 4,724</b>               | <b>\$ 4,048</b> | <b>\$ 8,950</b>                  | <b>\$ 11,590</b> |

The slight increase in salaries and benefits expense during the first six months of 2013 compared to the first six months of 2012 reflected routine increases in salaries and wages, partially offset by a reduction in full-time equivalents, lower group health insurance costs and officer bonus accruals. Beginning in 2013, the Company returned to a fully insured group health plan and was able to lower its benefits costs compared to 2012. Previously, the Company's group health plan was self insured.

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Salaries and benefits expense declined in the second quarter of 2013 when compared to the second quarter of 2012 due to a reduction in full-time equivalents, lower group health insurance costs and officer bonus accruals. This decrease was partially offset by routine increases in salaries and wages.

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During the first six months of 2013, the Company repaid \$20.0 million of FHLB advances with a weighted average interest rate of 3.38% and incurred prepayment penalties of \$1.5 million. During the first six months of 2012, the Company repaid \$38.0 million of FHLB advances with a weighted average interest rate of 4.26% and incurred prepayment penalties of \$3.7 million.

During the second quarter of 2013, the Company repaid \$10.0 million of FHLB advances with a weighted average interest rate of 3.59% and incurred prepayment penalties of \$1.0 million.

**Income Tax Expense**

Income tax expense was approximately \$1.2 million for the first six months of 2013, compared to \$0.7 million in the first six months of 2012. The Company's effective tax rate for the first six months of 2013 was 24.28%, compared to 16.83% in the first six months of 2012. The Company's effective tax rate increased during the first six months of 2013 when compared to the first six months of 2012 primarily due to an increase in the level of earnings before taxes and the Company's annualized effective tax rate for 2012 was reduced by the reversal of a deferred tax valuation allowance of \$0.5 million related to capital loss carry-forwards.

**BALANCE SHEET ANALYSIS****Securities**

Securities available-for-sale were \$270.8 million and \$259.5 million as of June 30, 2013 and December 31, 2012, respectively. Unrealized net losses on securities available-for-sale were \$2.9 million at June 30, 2013 compared to unrealized net gains of \$8.2 million at December 31, 2012. The change in unrealized gains (losses) on securities available-for-sale was due to an increase in long-term interest rates during the first six months of 2013.

The average tax-equivalent yields earned on total securities were 3.03% in the first six months of 2013 and 3.18% in the first six months of 2012.

**Loans**

| <i>(In thousands)</i>             | 2013           |               |                | 2012          |                |
|-----------------------------------|----------------|---------------|----------------|---------------|----------------|
|                                   | Second Quarter | First Quarter | Fourth Quarter | Third Quarter | Second Quarter |
| Commercial and industrial         | \$ 56,030      | 55,736        | 59,334         | 58,579        | 59,418         |
| Construction and land development | 45,886         | 41,104        | 37,631         | 40,573        | 38,968         |
| Commercial real estate            | 177,291        | 178,993       | 183,611        | 183,757       | 185,846        |
| Residential real estate           | 99,021         | 102,978       | 105,631        | 103,319       | 104,227        |
| Consumer installment              | 12,747         | 12,026        | 12,219         | 11,747        | 11,133         |
| Total loans                       | 390,975        | 390,837       | 398,426        | 397,975       | 399,592        |
| Less: unearned income             | (249)          | (267)         | (233)          | (237)         | (222)          |
| Loans, net of unearned income     | \$ 390,726     | 390,570       | 398,193        | 397,738       | 399,370        |

Total loans, net of unearned income, were \$390.7 million at June 30, 2013, compared to \$398.2 million at December 31, 2012. The majority of the decrease related to payoffs received on nonaccrual loans during the first quarter of 2013. Three loans were repaid that had carrying amounts of \$5.9 million at December 31, 2012. Four loan categories represented the majority of the loan portfolio at June 30, 2013: commercial real estate (45%), residential real estate (25%), construction and land development (12%) and commercial and industrial (14%). Approximately 34% of the Company's commercial real estate loans were classified as owner-occupied at June 30, 2013.

Within the residential real estate portfolio segment, the Company had junior lien mortgages of approximately \$15.5 million, or 4% of total loans, at June 30, 2013, compared to \$15.8 million, or 4% of total loans, at December 31, 2012. For residential real estate mortgage loans with a consumer purpose, approximately \$1.1 million and \$1.3 million required interest-only payments at June 30, 2013 and December 31, 2012,

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.

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Purchased loan participations included in the Company's loan portfolio were approximately \$4.0 million and \$3.1 million at June 30, 2013 and December 31, 2012, 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 described under **CRITICAL ACCOUNTING POLICIES - Allowance for Loan Losses**.

The average yield earned on loans and loans held for sale was 5.37% in the first six months of 2013 and 5.57% in the first six months of 2012.

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, availability and cost of financing 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 the 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 \$15.8 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$14.2 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At June 30, 2013, 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 categorize our commercial borrowers. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank's total risk-based capital at June 30, 2013 (and related balances at December 31, 2012).

| <i>(In thousands)</i>                           | <b>June 30,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|---|--------------------------|------------------------------|
| Lessors of 1 to 4 family residential properties | \$ 43,829                | \$ 47,544                    |
| Multi-family residential properties             | 32,393                   | 30,392                       |
| Shopping centers                                | 25,935                   | 20,760                       |
| Office buildings                                | 20,286                   | 20,925                       |

**Table of Contents****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 inherent in the loan portfolio. At June 30, 2013 and December 31, 2012, the allowance for loan losses was \$6.5 million and \$6.7 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 the second quarter of 2013 and the previous four quarters is presented below.

| <i>(Dollars in thousands)</i>                      | 2013           |               |                | 2012          |                |
|--|----------------|---------------|----------------|---------------|----------------|
|  | Second Quarter | First Quarter | Fourth Quarter | Third Quarter | Second Quarter |
| Balance at beginning of period                     | \$ 6,769       | 6,723         | 6,045          | 6,503         | 7,496          |
| Charge-offs:                                       |                |               |                |               |                |
| Commercial and industrial                          |                | (68)          | (42)           | (152)         | (95)           |
| Construction and land development                  |                | (39)          |                |               | (231)          |
| Commercial real estate                             | (118)          |               | (340)          | (1,626)       | (1,218)        |
| Residential real estate                            | (189)          | (266)         | (110)          | (324)         | (78)           |
| Consumer installment                               | (45)           | (17)          | (17)           | (35)          | (26)           |
| Total charge-offs                                  | (352)          | (390)         | (509)          | (2,137)       | (1,648)        |
| Recoveries   | 40             | 36            | 122            | 129           | 55             |
| Net charge-offs                                    | (312)          | (354)         | (387)          | (2,008)       | (1,593)        |
| Provision for loan losses                          |                | 400           | 1,065          | 1,550         | 600            |
| Ending balance                                     | \$ 6,457       | 6,769         | 6,723          | 6,045         | 6,503          |
| as a % of loans                                    | 1.65 %         | 1.73          | 1.69           | 1.52          | 1.63           |
| as a % of nonperforming loans                      | 138 %          | 143           | 64             | 44            | 79             |
| Annualized net charge-offs as a % of average loans | 0.32 %         | 0.36          | 0.39           | 2.00          | 1.61           |

As described 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 loss rates 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 1.65% at June 30, 2013, compared to 1.69% at December 31, 2012. 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. In addition, our regulators, as an integral part of their examination process, will periodically review the Company's allowance for loan losses, and may require the Company to make additional provisions to the allowance for losses based on their judgement about information available to them at the time of their examinations.

At June 30, 2013, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 138%, compared to 64% at December 31, 2012. The increase was primarily due to payoffs received on three nonperforming commercial real estate loans during the first quarter of 2013 with a total recorded investment of \$5.9 million and no related allowance for loan losses at December 31, 2012. Excluding these nonperforming loans, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 144% at December 31, 2012.

At June 30, 2013, the Company's recorded investment in loans considered impaired was \$5.4 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$0.3 million. 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.

**Table of Contents****Nonperforming Assets**

At June 30, 2013, the Company had \$8.3 million in nonperforming assets, compared to \$15.5 million at December 31, 2012. Nonperforming assets decreased primarily due to payoffs received on three nonperforming commercial real estate loans during the first quarter of 2013 with a total recorded investment of \$5.9 million at December 31, 2012. The majority of the balance in nonperforming assets at June 30, 2013 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 for the second quarter of 2013 and the previous four quarters.

| <i>(Dollars in thousands)</i>               | <b>2013</b>               |                          |                           |                                   |                           |
|---|---------------------------|--------------------------|---------------------------|-----------------------------------|---------------------------|
|   | <b>Second<br/>Quarter</b> | <b>First<br/>Quarter</b> | <b>Fourth<br/>Quarter</b> | <b>2012<br/>Third<br/>Quarter</b> | <b>Second<br/>Quarter</b> |
| <b>Nonperforming assets:</b>                |                           |                          |                           |                                   |                           |
| Nonaccrual loans                            | \$ 4,664                  | 4,748                    | 10,535                    | 13,635                            | 8,228                     |
| Other real estate owned                     | 3,609                     | 4,810                    | 4,919                     | 4,925                             | 5,157                     |
| <b>Total nonperforming assets</b>           | <b>\$ 8,273</b>           | <b>9,558</b>             | <b>15,454</b>             | <b>18,560</b>                     | <b>13,385</b>             |
| as a % of loans and other real estate owned | 2.10 %                    | 2.42                     | 3.83                      | 4.61                              | 3.31                      |
| as a % of total assets                      | 1.08 %                    | 1.24                     | 2.03                      | 2.46                              | 1.75                      |
| Nonperforming loans as a % of total loans   | 1.19 %                    | 1.22                     | 2.65                      | 3.43                              | 2.06                      |
| Accruing loans 90 days or more past due     | \$                        |                          | 58                        | 13                                | 6                         |

The table below provides information concerning the composition of nonaccrual loans for the second quarter of 2013 and the previous four quarters.

| <i>(In thousands)</i>             | <b>2013</b>               |                          |                           |                                   |                           |
|-----------------------------------|---------------------------|--------------------------|---------------------------|-----------------------------------|---------------------------|
|                                   | <b>Second<br/>Quarter</b> | <b>First<br/>Quarter</b> | <b>Fourth<br/>Quarter</b> | <b>2012<br/>Third<br/>Quarter</b> | <b>Second<br/>Quarter</b> |
| <b>Nonaccrual loans:</b>          |                           |                          |                           |                                   |                           |
| Commercial and industrial         | \$ 57                     | 59                       | 60                        | 93                                | 97                        |
| Construction and land development | 1,601                     | 1,615                    | 1,706                     | 3,840                             | 3,858                     |
| Commercial real estate            | 1,484                     | 1,610                    | 6,714                     | 7,207                             | 2,113                     |
| Residential real estate           | 1,520                     | 1,459                    | 2,055                     | 2,495                             | 2,160                     |
| Consumer installment              | 2                         | 5                        |                           |                                   |                           |
| <b>Total nonaccrual loans</b>     | <b>\$ 4,664</b>           | <b>4,748</b>             | <b>10,535</b>             | <b>13,635</b>                     | <b>8,228</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 90 days or more past due, unless the loan is both well-secured and in the process of collection. At June 30, 2013, the Company had \$4.7 million in loans on nonaccrual, compared to \$10.5 million at December 31, 2012.

At June 30, 2013 there were no loans 90 days or more past due and still accruing interest compared to \$58,000 at December 31, 2012.





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The table below provides information concerning the composition of other real estate owned for the second quarter of 2013 and the previous four quarters.

| <i>(In thousands)</i>                | 2013              |                  |                   | 2012             |                   |
|--------------------------------------|-------------------|------------------|-------------------|------------------|-------------------|
|                                      | Second<br>Quarter | First<br>Quarter | Fourth<br>Quarter | Third<br>Quarter | Second<br>Quarter |
| <b>Other real estate owned:</b>      |                   |                  |                   |                  |                   |
| <b>Commercial:</b>                   |                   |                  |                   |                  |                   |
| Buildings                            | \$ 535            | 540              | 608               | 707              | 615               |
| Developed lots                       | 1,275             | 1,275            | 1,275             | 1,285            | 1,285             |
| <b>Residential:</b>                  |                   |                  |                   |                  |                   |
| Condominiums                         |                   |                  | 425               | 982              | 1,016             |
| Undeveloped Land                     | 242               | 1,464            | 1,464             | 1,671            | 1,671             |
| Other                                | 1,557             | 1,531            | 1,147             | 280              | 570               |
| <b>Total other real estate owned</b> | <b>\$ 3,609</b>   | <b>4,810</b>     | <b>4,919</b>      | <b>4,925</b>     | <b>5,157</b>      |

At June 30, 2013 and December 31, 2012, respectively, the Company held \$3.6 million and \$4.9 million in OREO, which we acquired from borrowers. At June 30, 2013, approximately 64% of the total balance in OREO related to properties acquired from two borrowers with a total carrying value of \$2.0 million.

**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 \$11.8 million, or 3.0% of total loans at June 30, 2013, compared to \$12.6 million, or 3.2% of total loans at December 31, 2012.

The table below provides information concerning the composition of performing potential problem loans for the second quarter of 2013 and the previous four quarters.

| <i>(In thousands)</i>                | 2013              |                  |                   | 2012             |                   |
|--------------------------------------|-------------------|------------------|-------------------|------------------|-------------------|
|                                      | Second<br>Quarter | First<br>Quarter | Fourth<br>Quarter | Third<br>Quarter | Second<br>Quarter |
| <b>Potential problem loans:</b>      |                   |                  |                   |                  |                   |
| Commercial and industrial            | \$ 884            | 555              | 563               | 503              | 545               |
| Construction and land development    | 1,201             | 1,288            | 1,125             | 852              | 944               |
| Commercial real estate               | 1,833             | 2,843            | 2,727             | 2,753            | 9,029             |
| Residential real estate              | 7,772             | 7,939            | 7,978             | 8,022            | 7,427             |
| Consumer installment                 | 146               | 197              | 214               | 206              | 133               |
| <b>Total potential problem loans</b> | <b>\$ 11,836</b>  | <b>12,822</b>    | <b>12,607</b>     | <b>12,336</b>    | <b>18,078</b>     |

At June 30, 2013, approximately \$0.7 million or 5.7% of total potential problem loans were past due at least 30 days but less than 90 days. At June 30, 2013, the remaining balance of potential problem loans were current or past due less than 30 days.



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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 for the second quarter of 2013 and the previous four quarters.

| <i>(In thousands)</i>                           | 2013              |                  |                   | 2012             |                   |
|---|-------------------|------------------|-------------------|------------------|-------------------|
|   | Second<br>Quarter | First<br>Quarter | Fourth<br>Quarter | Third<br>Quarter | Second<br>Quarter |
| <b>Performing loans past due 30 to 89 days:</b> |                   |                  |                   |                  |                   |
| Commercial and industrial                       | \$ 329            | 47               | 173               | 393              | 321               |
| Construction and land development               |                   | 135              | 8                 |                  | 270               |
| Commercial real estate                          | 1,498             |                  | 230               |                  | 92                |
| Residential real estate                         | 501               | 403              | 1,537             | 718              | 1,008             |
| Consumer installment                            | 147               | 36               | 62                | 27               | 59                |
| <b>Total</b>                                    | <b>\$ 2,475</b>   | <b>621</b>       | <b>2,010</b>      | <b>1,138</b>     | <b>1,750</b>      |

**Deposits**

Total deposits were \$666.5 million at June 30, 2013, compared to \$636.8 million at December 31, 2012. Noninterest bearing deposits were \$127.2 million, or 19.1% of total deposits, at June 30, 2013, compared to \$118.0 million, or 18.5% of total deposits at December 31, 2012. The increase in total deposits of \$29.7 million reflects growth and changes in customer preferences for short-term instruments in a low interest rate environment.

The average rate paid on total interest-bearing deposits was 1.04% in the first six months of 2013 and 1.26% in the first six months of 2012.

**Other Borrowings**

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity less than one year. The Bank had available federal funds lines totaling \$41.0 million and \$40.0 million with \$2.4 million and none outstanding at June 30, 2013 and December 31, 2012, respectively. Securities sold under agreements to repurchase totaled \$2.6 million and \$2.7 million at June 30, 2013 and December 31, 2012, respectively.

The average rate paid on short-term borrowings was 0.51% in the first six months of 2013 and 0.55% in the first six months of 2012.

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 \$5.0 million and \$25.0 million in long-term FHLB advances at June 30, 2013 and December 31, 2012, respectively. During the first six months of 2013, the Company repaid \$20.0 million of FHLB advances with a weighted average interest rate of 3.38%. In addition, the Bank 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 at both June 30, 2013 and December 31, 2012.

The average rate paid on long-term debt was 3.62% in the first six months of 2013 and 3.76% in the first six months of 2012.

**CAPITAL ADEQUACY**

The Company's consolidated stockholders' equity was \$65.2 million and \$70.1 million as of June 30, 2013 and December 31, 2012, respectively. The change from December 31, 2012 was primarily driven by an other comprehensive loss due to the change in unrealized gains (losses) on securities available-for-sale of \$7.0 million and cash dividends paid of \$1.5 million, partially offset by net earnings of \$3.6 million.

The Company's tier 1 leverage ratio was 9.76%, tier 1 risk-based capital ratio was 16.45% and total risk-based capital ratio was 17.70% at June 30, 2013. These ratios exceed the minimum regulatory capital percentages of 5.0% for tier 1 leverage ratio, 6.0% for tier 1 risk-based capital ratio and 10.0% for total risk-based capital ratio to be considered well-capitalized. Based on current regulatory standards, the Company is

classified as well capitalized.

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### **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 sensitivity and liquidity risk management.

#### **Interest Rate Sensitivity Management**

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates. ALCO measures and evaluates interest rate risk so that the Bank can meet customer demands for various types of loans and deposits. Measurements used to help manage interest rate sensitivity include an earnings simulation model and an economic value of equity model.

Management uses earnings simulation modeling to estimate and manage interest rate risk. 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 are combined with 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% decline for a 200 basis point change up or down in rates from management's flat interest rate forecast over the next twelve months. The results of our current simulation model indicate that we were in compliance with our current guidelines at June 30, 2013.

Economic value of equity 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 economic value of equity. 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, the economic value of equity should not decrease by more than 25%. The results of our current economic value of equity model indicate that we were in compliance with our guidelines at June 30, 2013.

Each of the above 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, including market perceptions. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types of assets and liabilities 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. 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 June 30, 2013 and December 31, 2012, the Company had no derivative contracts designated as part of a hedging relationship to assist in managing its interest rate sensitivity.

#### **Liquidity Risk Management**

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

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



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The primary source of funding and the primary source of liquidity for the Company include dividends received from the Bank, and secondarily proceeds from the possible issuance of common stock or other securities. Primary uses of funds for the Company include dividends paid to stockholders, 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 accompanying Consolidated Balance Sheets and the related trust preferred securities are currently 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, sales 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. At June 30, 2013, the Bank had a remaining available line of credit with the FHLB totaling \$220.1 million. At June 30, 2013, the Bank also had \$41.0 million of available federal funds lines with \$2.4 million outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

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

### **Off-Balance Sheet Arrangements, Commitments and Contingencies**

At June 30, 2013, the Bank had outstanding standby letters of credit of \$8.8 million and unfunded loan commitments outstanding of \$44.6 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 could liquidate federal funds sold or a portion of securities available-for-sale, or draw on its available credit facilities.

#### *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 June 30, 2013, the unpaid principal balance of the residential mortgage loans, which we have originated and sold, but retained the servicing rights was \$341.1 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.

We were not required to repurchase any residential mortgage loans in the first six months of 2013. During the full year 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 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.



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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 June 30, 2013, 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 99.4% 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.

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

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

### **CURRENT ACCOUNTING DEVELOPMENTS**

There were no accounting pronouncements issued by the FASB, but not yet effective that management currently expects will have a significant impact on the Company's consolidated financial statements.

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

In addition to results presented in accordance with U.S. generally accepted accounting principles (GAAP), this quarterly report on Form 10-Q 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 reconciliations of these non-GAAP financial measures to their most directly comparable GAAP financial measures are presented below.

| <i>(In thousands)</i>                       | 2013           |               |                | 2012          |                |
|---|----------------|---------------|----------------|---------------|----------------|
|   | Second Quarter | First Quarter | Fourth Quarter | Third Quarter | Second Quarter |
| <b>Net interest income (GAAP)</b>           | \$ 5,232       | 5,141         | 5,325          | 5,259         | 5,312          |
| Tax-equivalent adjustment                   | 365            | 382           | 396            | 416           | 416            |
| <b>Net interest income (Tax-equivalent)</b> | \$ 5,597       | 5,523         | 5,721          | 5,675         | 5,728          |

| <i>(In thousands)</i>                       | Six months ended June 30, |        |
|---|---------------------------|--------|
|   | 2013                      | 2012   |
| <b>Net interest income (GAAP)</b>           | \$ 10,373                 | 10,313 |
| Tax-equivalent adjustment                   | 747                       | 830    |
| <b>Net interest income (Tax-equivalent)</b> | \$ 11,120                 | 11,143 |

**Table of Contents****Table 2 Selected Quarterly Financial Data**

|   | 2013              |                  |                   | 2012             |                   |
|---|-------------------|------------------|-------------------|------------------|-------------------|
|   | Second<br>Quarter | First<br>Quarter | Fourth<br>Quarter | Third<br>Quarter | Second<br>Quarter |
| <i>(Dollars in thousands, except per share amounts)</i> |                   |                  |                   |                  |                   |
| <b>Results of Operations</b>                            |                   |                  |                   |                  |                   |
| Net interest income (a)                                 | \$ 5,597          | 5,523            | 5,721             | 5,675            | 5,728             |
| Less: tax-equivalent adjustment                         | 365               | 382              | 396               | 416              | 416               |
| Net interest income (GAAP)                              | 5,232             | 5,141            | 5,325             | 5,259            | 5,312             |
| Noninterest income                                      | 2,071             | 1,655            | 1,788             | 2,017            | 1,814             |
| Total revenue   | 7,303             | 6,796            | 7,113             | 7,276            | 7,126             |
| Provision for loan losses                               |                   | 400              | 1,065             | 1,550            | 600               |
| Noninterest expense                                     | 4,724             | 4,226            | 4,023             | 3,770            | 4,048             |
| Income tax expense                                      | 672               | 481              | 365               | 347              | 449               |
| Net earnings  | \$ 1,907          | 1,689            | 1,660             | 1,609            | 2,029             |
| <b>Per share data:</b>                                  |                   |                  |                   |                  |                   |
| Basic and diluted net earnings                          | \$ 0.52           | 0.46             | 0.46              | 0.44             | 0.56              |
| Cash dividends declared                                 | 0.21              | 0.21             | 0.205             | 0.205            | 0.205             |
| Weighted average shares outstanding:                    |                   |                  |                   |                  |                   |
| Basic and diluted                                       | 3,642,955         | 3,642,918        | 3,642,903         | 3,642,876        | 3,642,826         |
| Shares outstanding                                      | 3,642,993         | 3,642,928        | 3,642,903         | 3,642,903        | 3,642,843         |
| Book value  | \$ 17.90          | 19.27            | 19.26             | 19.27            | 18.75             |
| Common stock price                                      |                   |                  |                   |                  |                   |
| High  | \$ 22.33          | 22.60            | 24.87             | 23.20            | 26.65             |
| Low   | 21.54             | 20.80            | 20.85             | 21.00            | 21.50             |
| Period end  | 22.00             | 22.00            | 20.85             | 22.25            | 21.50             |
| To earnings ratio                                       | 11.70x            | 11.46            | 11.21             | 12.94            | 12.95             |
| To book value   | 123 %             | 114              | 108               | 115              | 115               |
| <b>Performance ratios:</b>                              |                   |                  |                   |                  |                   |
| Return on average equity                                | 10.74 %           | 9.47             | 9.30              | 9.22             | 12.06             |
| Return on average assets                                | 1.00 %            | 0.87             | 0.88              | 0.86             | 1.07              |
| Dividend payout ratio                                   | 40.38 %           | 45.65            | 44.57             | 46.59            | 36.61             |
| <b>Asset Quality:</b>                                   |                   |                  |                   |                  |                   |
| Allowance for loan losses as a % of:                    |                   |                  |                   |                  |                   |
| Loans   | 1.65 %            | 1.73             | 1.69              | 1.52             | 1.63              |
| Nonperforming loans                                     | 138 %             | 143              | 64                | 44               | 79                |
| Nonperforming assets as a % of:                         |                   |                  |                   |                  |                   |
| Loans and other real estate owned                       | 2.10 %            | 2.42             | 3.83              | 4.61             | 3.31              |
| Total assets  | 1.08 %            | 1.24             | 2.03              | 2.46             | 1.75              |
| Nonperforming loans as a % of total loans               |                   |                  |                   |                  |                   |
|   | 1.19 %            | 1.22             | 2.65              | 3.43             | 2.06              |
| Annualized net charge-offs as a % of average loans      | 0.32 %            | 0.36             | 0.39              | 2.00             | 1.61              |
| <b>Capital Adequacy:</b>                                |                   |                  |                   |                  |                   |
| Tier 1 risk-based capital ratio                         | 16.45 %           | 16.32            | 16.20             | 15.75            | 15.39             |
| Total risk-based capital ratio                          | 17.70 %           | 17.57            | 17.46             | 17.00            | 16.65             |
| Tier 1 Leverage Ratio                                   | 9.76 %            | 9.42             | 9.58              | 9.54             | 9.26              |
| <b>Other financial data:</b>                            |                   |                  |                   |                  |                   |
| Net interest margin (a)                                 | 3.16 %            | 3.09             | 3.22              | 3.23             | 3.26              |
| Effective income tax rate                               | 26.06 %           | 22.17            | 18.02             | 17.74            | 18.12             |
| Efficiency ratio (b)                                    | 61.61 %           | 58.87            | 53.58             | 49.01            | 53.67             |
| <b>Selected average balances:</b>                       |                   |                  |                   |                  |                   |
| Securities  | \$ 266,056        | 263,074          | 253,765           | 265,670          | 293,072           |
| Loans, net of unearned income                           | 389,402           | 396,436          | 395,487           | 401,166          | 395,261           |
| Total assets  | 761,534           | 777,756          | 755,991           | 748,055          | 760,413           |
| Total deposits  | 652,952           | 653,802          | 630,950           | 624,813          | 639,182           |
| Long-term debt  | 31,613            | 46,661           | 47,217            | 47,217           | 47,241            |
| Total stockholders' equity                              | 71,006            | 71,317           | 71,421            | 69,826           | 67,296            |
| <b>Selected period end balances:</b>                    |                   |                  |                   |                  |                   |
| Securities  | \$ 270,794        | 270,219          | 259,475           | 254,819          | 277,246           |
| Loans, net of unearned income                           | 390,726           | 390,570          | 398,193           | 397,738          | 399,370           |
| Allowance for loan losses                               | 6,457             | 6,769            | 6,723             | 6,045            | 6,503             |

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|                            |         |         |         |         |         |
|----------------------------|---------|---------|---------|---------|---------|
| Total assets               | 767,747 | 772,155 | 759,833 | 753,467 | 766,161 |
| Total deposits             | 666,490 | 659,056 | 636,817 | 629,824 | 644,246 |
| Long-term debt             | 27,217  | 37,217  | 47,217  | 47,217  | 47,217  |
| Total stockholders' equity | 65,211  | 70,217  | 70,149  | 70,206  | 68,292  |

(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 of Contents****Table 3 Selected Financial Data**

| <i>(Dollars in thousands, except per share amounts)</i> | <b>Six months ended June 30,</b> |             |
|---|----------------------------------|-------------|
|   | <b>2013</b>                      | <b>2012</b> |
| <b>Results of Operations</b>                            |                                  |             |
| Net interest income (a)                                 | \$ 11,120                        | 11,143      |
| Less: tax-equivalent adjustment                         | 747                              | 830         |
| Net interest income (GAAP)                              | 10,373                           | 10,313      |
| Noninterest income                                      | 3,726                            | 6,678       |
| Total revenue   | 14,099                           | 16,991      |
| Provision for loan losses                               | 400                              | 1,200       |
| Noninterest expense                                     | 8,950                            | 11,590      |
| Income tax expense                                      | 1,153                            | 707         |
| Net earnings  | \$ 3,596                         | 3,494       |
| <b>Per share data:</b>                                  |                                  |             |
| Basic and diluted net earnings                          | \$ 0.99                          | 0.96        |
| Cash dividends declared                                 | 0.42                             | 0.41        |
| Weighted average shares outstanding:                    |                                  |             |
| Basic and diluted                                       | 3,642,936                        | 3,642,782   |
| Shares outstanding, at period end                       | 3,642,993                        | 3,642,843   |
| Book value  | \$ 17.90                         | 18.75       |
| Common stock price                                      |                                  |             |
| High  | \$ 22.60                         | 26.65       |
| Low   | 20.80                            | 18.23       |
| Period end  | 22.00                            | 21.50       |
| To earnings ratio                                       | 11.70x                           | 12.95       |
| To book value   | 123 %                            | 115         |
| <b>Performance ratios:</b>                              |                                  |             |
| Return on average equity                                | 10.11 %                          | 10.48       |
| Return on average assets                                | 0.93 %                           | 0.92        |
| Dividend payout ratio                                   | 42.42 %                          | 42.71       |
| <b>Asset Quality:</b>                                   |                                  |             |
| Allowance for loan losses as a % of:                    |                                  |             |
| Loans   | 1.65 %                           | 1.63        |
| Nonperforming loans                                     | 138 %                            | 79          |
| Nonperforming assets as a % of:                         |                                  |             |
| Loans and other real estate owned                       | 2.10 %                           | 3.31        |
| Total assets  | 1.08 %                           | 1.75        |
| Nonperforming loans as a % of total loans               | 1.19 %                           | 2.06        |
| Annualized net charge-offs as a % of average loans      | 0.34 %                           | 0.84        |
| <b>Capital Adequacy:</b>                                |                                  |             |
| Tier 1 risk-based capital ratio                         | 16.45 %                          | 15.39       |
| Total risk-based capital ratio                          | 17.70 %                          | 16.65       |
| Tier 1 Leverage Ratio                                   | 9.76 %                           | 9.26        |
| <b>Other financial data:</b>                            |                                  |             |
| Net interest margin (a)                                 | 3.12 %                           | 3.19        |
| Effective income tax rate                               | 24.28 %                          | 16.83       |
| Efficiency ratio (b)                                    | 60.29 %                          | 65.04       |
| <b>Selected average balances:</b>                       |                                  |             |
| Securities  | \$ 264,574                       | 294,955     |
| Loans, net of unearned income                           | 392,899                          | 386,212     |
| Total assets  | 769,602                          | 758,623     |
| Total deposits  | 653,375                          | 634,418     |
| Long-term debt  | 39,095                           | 51,033      |
| Total stockholders' equity                              | 71,162                           | 66,707      |
| <b>Selected period end balances:</b>                    |                                  |             |
| Securities  | \$ 270,794                       | 277,246     |
| Loans, net of unearned income                           | 390,726                          | 399,370     |
| Allowance for loan losses                               | 6,457                            | 6,503       |
| Total assets  | 767,747                          | 766,161     |

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|                            |         |         |
|----------------------------|---------|---------|
| Total deposits             | 666,490 | 644,246 |
| Long-term debt             | 27,217  | 47,217  |
| Total stockholders' equity | 65,211  | 68,292  |

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

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

**Table of Contents****Table 4 Average Balances and Net Interest Income Analysis**

| <i>(Dollars in thousands)</i>  | Average<br>Balance | Quarter ended June 30,                 |                |                    | 2012<br>Interest<br>Income/<br>Expense | Yield/<br>Rate |
|--|--------------------|--|----------------|--------------------|--|----------------|
|  |                    | 2013<br>Interest<br>Income/<br>Expense | Yield/<br>Rate | Average<br>Balance |  |                |
| <b>Interest-earning assets:</b>  |                    |  |                |                    |  |                |
| Loans and loans held for sale (1)  | \$ 392,973         | \$ 5,224                               | bl             | \$ 397,221         | \$ 5,490                               | 5.56%          |
| Securities taxable   | 197,165            | 901                                    | 1.83%          | 214,557            | 1,051                                  | 1.97%          |
| Securities tax-exempt (2)  | 68,891             | 1,071                                  | 6.24%          | 78,515             | 1,225                                  | 6.28%          |
| Total securities   | 266,056            | 1,972                                  | 2.97%          | 293,072            | 2,276                                  | 3.12%          |
| Federal funds sold   | 51,004             | 29                                     | 0.23%          | 14,786             | 7                                      | 0.19%          |
| Interest bearing bank deposits   | 1,187              |  |                | 883                |  |                |
| Total interest-earning assets  | 711,220            | \$ 7,225                               | 4.07%          | 705,962            | \$ 7,773                               | 4.43%          |
| Cash and due from banks  | 13,932             |  |                | 13,815             |  |                |
| Other assets   | 36,382             |  |                | 40,636             |  |                |
| Total assets   | \$ 761,534         |  |                | \$ 760,413         |  |                |
| <b>Interest-bearing liabilities:</b>                                     |                    |  |                |                    |  |                |
| Deposits:  |                    |  |                |                    |  |                |
| NOW  | \$ 104,132         | \$ 83                                  | 0.32%          | \$ 105,129         | \$ 83                                  | 0.32%          |
| Savings and money market   | 168,594            | 217                                    | 0.52%          | 157,023            | 211                                    | 0.54%          |
| Certificates of deposits less than<br>\$100,000                          | 105,613            | 364                                    | 1.38%          | 109,672            | 453                                    | 1.66%          |
| Certificates of deposits and other time<br>deposits of \$100,000 or more | 153,644            | 685                                    | 1.79%          | 160,424            | 858                                    | 2.15%          |
| Total interest-bearing deposits  | 531,983            | 1,349                                  | 1.02%          | 532,248            | 1,605                                  | 1.21%          |
| Short-term borrowings  | 2,647              | 3                                      | 0.45%          | 3,530              | 5                                      | 0.57%          |
| Long-term debt   | 31,613             | 276                                    | 3.50%          | 47,241             | 435                                    | 3.70%          |
| Total interest-bearing liabilities                                       | 566,243            | \$ 1,628                               | 1.15%          | 583,019            | \$ 2,045                               | 1.41%          |
| Noninterest-bearing deposits   | 120,969            |  |                | 106,934            |  |                |
| Other liabilities  | 3,316              |  |                | 3,164              |  |                |
| Stockholders equity  | 71,006             |  |                | 67,296             |  |                |
| Total liabilities and stockholders<br>equity                             | \$ 761,534         |  |                | \$ 760,413         |  |                |
| Net interest income and margin<br>(tax-equivalent)                       |                    | \$ 5,597                               | 3.16%          |                    | \$ 5,728                               | 3.26%          |

- (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 of Contents****Table 5 Average Balances and Net Interest Income Analysis**

| <i>(Dollars in thousands)</i>   | <b>Six months ended June 30,</b> |   |                |                    |   |                |
|---|----------------------------------|---|----------------|--------------------|---|----------------|
|   | Average<br>Balance               | <b>2013</b><br>Interest<br>Income/<br>Expense | Yield/<br>Rate | Average<br>Balance | <b>2012</b><br>Interest<br>Income/<br>Expense | Yield/<br>Rate |
| <b>Interest-earning assets:</b>                                       |                                  |   |                |                    |   |                |
| Loans and loans held for sale (1)                                     | \$ 396,498                       | \$ 10,552                                     | 5.37%          | \$ 388,398         | \$ 10,755                                     | 5.57%          |
| Securities taxable  | 194,205                          | 1,773   | 1.84%          | 216,675            | 2,219   | 2.06%          |
| Securities tax-exempt (2)   | 70,369                           | 2,197   | 6.30%          | 78,280             | 2,440   | 6.27%          |
| Total securities  | 264,574                          | 3,970   | 3.03%          | 294,955            | 4,659   | 3.18%          |
| Federal funds sold  | 55,881                           | 60  | 0.22%          | 18,195             | 21  | 0.23%          |
| Interest bearing bank deposits  | 892                              |   |                | 1,032              |   |                |
| Total interest-earning assets   | 717,845                          | \$ 14,582                                     | 4.10%          | 702,580            | \$ 15,435                                     | 4.42%          |
| Cash and due from banks   | 15,217                           |   |                | 14,352             |   |                |
| Other assets  | 36,540                           |   |                | 41,691             |   |                |
| Total assets  | \$ 769,602                       |   |                | \$ 758,623         |   |                |
| <b>Interest-bearing liabilities:</b>                                  |                                  |   |                |                    |   |                |
| Deposits:   |                                  |   |                |                    |   |                |
| NOW   | \$ 104,851                       | \$ 166  | 0.32%          | \$ 101,651         | \$ 198  | 0.39%          |
| Savings and money market  | 168,263                          | 434   | 0.52%          | 154,029            | 450   | 0.59%          |
| Certificates of deposits less than \$100,000                          | 105,533                          | 745   | 1.42%          | 110,451            | 928   | 1.69%          |
| Certificates of deposits and other time deposits of \$100,000 or more | 154,745                          | 1,408   | 1.83%          | 163,437            | 1,754   | 2.16%          |
| Total interest-bearing deposits                                       | 533,392                          | 2,753   | 1.04%          | 529,568            | 3,330   | 1.26%          |
| Short-term borrowings   | 2,754                            | 7   | 0.51%          | 3,299              | 9   | 0.55%          |
| Long-term debt  | 39,095                           | 702   | 3.62%          | 51,033             | 953   | 3.76%          |
| Total interest-bearing liabilities                                    | 575,241                          | \$ 3,462                                      | 1.21%          | 583,900            | \$ 4,292                                      | 1.48%          |
| Noninterest-bearing deposits  | 119,983                          |   |                | 104,850            |   |                |
| Other liabilities   | 3,216                            |   |                | 3,166              |   |                |
| Stockholders equity   | 71,162                           |   |                | 66,707             |   |                |
| Total liabilities and stockholders equity                             | \$ 769,602                       |   |                | \$ 758,623         |   |                |
| Net interest income and margin (tax-equivalent)                       |                                  | \$ 11,120                                     | 3.12%          |                    | \$ 11,143                                     | 3.19%          |

- (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 of Contents****Table 6 Loan Portfolio Composition**

| <i>(In thousands)</i>             | 2013              |                  |                   | 2012             | Second  |
|-----------------------------------|-------------------|------------------|-------------------|------------------|---------|
|                                   | Second<br>Quarter | First<br>Quarter | Fourth<br>Quarter | Third<br>Quarter | Quarter |
| Commercial and industrial         | \$ 56,030         | 55,736           | 59,334            | 58,579           | 59,418  |
| Construction and land development | 45,886            | 41,104           | 37,631            | 40,573           | 38,968  |
| Commercial real estate            | 177,291           | 178,993          | 183,611           | 183,757          | 185,846 |
| Residential real estate           | 99,021            | 102,978          | 105,631           | 103,319          | 104,227 |
| Consumer installment              | 12,747            | 12,026           | 12,219            | 11,747           | 11,133  |
| Total loans                       | 390,975           | 390,837          | 398,426           | 397,975          | 399,592 |
| Less: unearned income             | (249)             | (267)            | (233)             | (237)            | (222)   |
| Loans, net of unearned income     | 390,726           | 390,570          | 398,193           | 397,738          | 399,370 |
| Less: allowance for loan losses   | (6,457)           | (6,769)          | (6,723)           | (6,045)          | (6,503) |
| Loans, net                        | \$ 384,269        | 383,801          | 391,470           | 391,693          | 392,867 |

**Table of Contents****Table 7 Allowance for Loan Losses and Nonperforming Assets**

|  | 2013              |                  |                   | 2012             |                   |
|--|-------------------|------------------|-------------------|------------------|-------------------|
|  | Second<br>Quarter | First<br>Quarter | Fourth<br>Quarter | Third<br>Quarter | Second<br>Quarter |
| <i>(Dollars in thousands)</i>                    |                   |                  |                   |                  |                   |
| <b>Allowance for loan losses:</b>                |                   |                  |                   |                  |                   |
| Balance at beginning of period                   | \$ 6,769          | 6,723            | 6,045             | 6,503            | 7,496             |
| Charge-offs:                                     |                   |                  |                   |                  |                   |
| Commercial and industrial                        |                   | (68)             | (42)              | (152)            | (95)              |
| Construction and land development                |                   | (39)             |                   |                  | (231)             |
| Commercial real estate                           | (118)             |                  | (340)             | (1,626)          | (1,218)           |
| Residential real estate                          | (189)             | (266)            | (110)             | (324)            | (78)              |
| Consumer installment                             | (45)              | (17)             | (17)              | (35)             | (26)              |
| Total charge-offs                                | (352)             | (390)            | (509)             | (2,137)          | (1,648)           |
| Recoveries                                       | 40                | 36               | 122               | 129              | 55                |
| Net charge-offs                                  | (312)             | (354)            | (387)             | (2,008)          | (1,593)           |
| Provision for loan losses                        |                   | 400              | 1,065             | 1,550            | 600               |
| Ending balance                                   | \$ 6,457          | 6,769            | 6,723             | 6,045            | 6,503             |
| as a % of loans                                  | 1.65%             | 1.73             | 1.69              | 1.52             | 1.63              |
| as a % of nonperforming loans                    | 138%              | 143              | 64                | 44               | 79                |
| Annualized net charge-offs as % of average loans | 0.32%             | 0.36             | 0.39              | 2.00             | 1.61              |
| <b>Nonperforming assets:</b>                     |                   |                  |                   |                  |                   |
| Nonaccrual loans                                 | \$ 4,664          | 4,748            | 10,535            | 13,635           | 8,228             |
| Other real estate owned                          | 3,609             | 4,810            | 4,919             | 4,925            | 5,157             |
| Total nonperforming assets                       | \$ 8,273          | 9,558            | 15,454            | 18,560           | 13,385            |
| as a % of loans and other real estate owned      | 2.10%             | 2.42             | 3.83              | 4.61             | 3.31              |
| as a % of total assets                           | 1.08%             | 1.24             | 2.03              | 2.46             | 1.75              |
| Nonperforming loans as a % of total loans        | 1.19%             | 1.22             | 2.65              | 3.43             | 2.06              |
| Accruing loans 90 days or more past due          | \$                |                  | 58                | 13               | 6                 |

**Table of Contents****Table 8 Allocation of Allowance for Loan Losses**

| <i>(Dollars in thousands)</i>     | 2013                     |      | First Quarter |      | 2012                     |      | Third Quarter |      | Second Quarter |      |
|-----------------------------------|--------------------------|------|---------------|------|--------------------------|------|---------------|------|----------------|------|
|                                   | Second Quarter<br>Amount | %*   | Amount        | %*   | Fourth Quarter<br>Amount | %*   | Amount        | %*   | Amount         | %*   |
| Commercial and industrial         | \$ 675                   | 14.3 | \$ 569        | 14.3 | \$ 812                   | 14.9 | \$ 754        | 14.7 | \$ 731         | 14.9 |
| Construction and land development | 1,454                    | 11.7 | 1,619         | 10.5 | 1,545                    | 9.4  | 1,609         | 10.2 | 1,623          | 9.8  |
| Commercial real estate            | 3,111                    | 45.3 | 3,571         | 45.8 | 3,137                    | 46.1 | 2,658         | 46.2 | 2,817          | 46.5 |
| Residential real estate           | 1,125                    | 25.3 | 885           | 26.3 | 1,126                    | 26.5 | 947           | 26.0 | 1,278          | 26.1 |
| Consumer installment              | 92                       | 3.3  | 125           | 3.1  | 103                      | 3.1  | 77            | 3.0  | 54             | 2.8  |
| Total allowance for loan losses   | \$ 6,457                 |      | \$ 6,769      |      | \$ 6,723                 |      | \$ 6,045      |      | \$ 6,503       |      |

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

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**Table of Contents****Table 9 CDs and Other Time Deposits of \$100,000 or More**

| <i>(Dollars in thousands)</i>                              | <b>June 30, 2013</b> |             |
|--|----------------------|-------------|
| <b>Maturity of:</b>  |                      |             |
| 3 months or less   | \$                   | 17,486      |
| Over 3 months through 6 months                             |                      | 25,589      |
| Over 6 months through 12 months                            |                      | 30,878      |
| Over 12 months   |                      | 82,468      |
| <br>Total CDs and other time deposits of \$100,000 or more | <br>\$               | <br>156,421 |

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information called for by ITEM 3 is set forth in ITEM 2 under the caption MARKET AND LIQUIDITY RISK MANAGEMENT and is incorporated herein by reference.

**ITEM 4. CONTROLS AND PROCEDURES**

The Company, with the participation of its management, including its Chief Executive Officer and Principal Financial and Accounting Officer, carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation and as of the end of the period covered by this report, the Company's Chief Executive Officer and Principal Financial and Accounting Officer concluded that the Company's disclosure controls and procedures were effective to allow timely decisions regarding disclosure in its reports that the Company files or submits to the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. There have been no changes in the Company's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

In the normal course of business, the Company and the Bank from time to time are involved in legal proceedings. The Company and Bank management believe there are no pending or threatened legal, governmental, or regulatory proceedings that upon resolution are expected to have a material adverse effect upon the Company's or the Bank's financial condition or results of operations. See also, Part I, Item 3 of the Company's annual report on Form 10-K for the year ended December 31, 2012.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I Item 1A. Risk Factors in our annual report on Form 10-K for the year ended December 31, 2012, which could materially affect our business, financial condition or future results. The risks described in our annual report on Form 10-K are not the only the risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results in the future.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

ISSUER PURCHASES OF EQUITY SECURITIES

| Period <sup>(1)</sup> | Total Number of<br>Shares<br>Purchased | Average Price Paid<br>per Share | Total Number of Shares  | Maximum Number of  |
|-----------------------|--|---------------------------------|---|--|
|                       |  |                                 | Purchased as Part of<br>Publicly Announced<br>Plans or Programs | Shares that May Yet Be<br>Purchased Under the<br>Plans or Programs |
| April 1 - April 30    |  |                                 |   |  |
| May 1 - May 31        |  |                                 |   |  |
| June 1 - June 30      |  |                                 |   |  |
| Total                 |  |                                 |   |  |

(1) Based on trade date, not settlement date.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.



**Table of Contents****ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

Not applicable.

**ITEM 6. EXHIBITS**

| Exhibit Number | Description   |
|----------------|---|
| 3.1            | Certificate of Incorporation of Auburn National Bancorporation, Inc. and all amendments thereto.*   |
| 3.2            | Amended and Restated Bylaws of Auburn National Bancorporation, Inc., adopted as of November 13, 2007. **  |
| 31.1           | Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.                                      |
| 31.2           | Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Vice President, Controller and Chief Financial Officer (Principal Financial and Accounting Officer). |
| 32.1           | Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Vice President, Controller and Chief Financial Officer (Principal Financial and Accounting Officer).***                             |
| 32.2           | Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.****   |
| 101.INS        | XBRL Instance Document*****   |
| 101.SCH        | XBRL Taxonomy Extension Schema Document*****  |
| 101.CAL        | XBRL Taxonomy Extension Calculation Linkbase Document*****  |
| 101.LAB        | XBRL Taxonomy Extension Label Linkbase Document*****  |
| 101.PRE        | XBRL Taxonomy Extension Presentation Linkbase Document*****   |
| 101.DEF        | XBRL Taxonomy Extension Definition Linkbase Document*****   |

\* Incorporated by reference from Registrant's Form 10-Q dated September 30, 2002.

\*\* Incorporated by reference from Registrant's Form 10-K dated March 31, 2008.

\*\*\* The certifications attached as exhibits 32.1 and 32.2 to this quarterly report on Form 10-Q are furnished to the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

\*\*\*\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AUBURN NATIONAL BANCORPORATION, INC.  
(Registrant)

Date: August 2, 2013

By: /s/ E. L. Spencer, Jr.  
E. L. Spencer, Jr.  
President, Chief Executive Officer and  
  
Chairman of the Board

Date: August 2, 2013

By: /s/ David A. Hedges  
David A. Hedges  
VP, Controller and Chief Financial Officer  
  
(Principal Financial and Accounting Officer)