

# FORM 10-Q

**(Exact Name of Registrant as Specified in Its Charter)**

Edgar Filing: AUBURN NATIONAL BANCORPORATION INC - Form 10-Q

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

**63-0885779**  
(I.R.S. Employer

Identification No.)

**100 N. Gay Street**

**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 ☒ (Do not check if a smaller reporting company) 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 April 30, 2010 |
|------------------------------------------|-------------------------------|
| Common Stock, \$0.01 par value per share | 3,643,132 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****Condensed Consolidated Balance Sheets****(Unaudited)**

|                                                                                                                         | March 31,<br>2010 | December 31,<br>2009 |
|-------------------------------------------------------------------------------------------------------------------------|-------------------|----------------------|
| <i>(Dollars in thousands, except share data)</i>                                                                        |                   |                      |
| <b>Assets:</b>                                                                                                          |                   |                      |
| Cash and due from banks                                                                                                 | \$ 11,997         | \$ 11,567            |
| Federal funds sold                                                                                                      | 11,990            |                      |
| Interest bearing bank deposits                                                                                          | 3,374             | 828                  |
| Cash and cash equivalents                                                                                               | 27,361            | 12,395               |
| Securities available-for-sale                                                                                           | 333,660           | 334,762              |
| Loans held for sale                                                                                                     | 3,977             | 4,881                |
| Loans, net of unearned income                                                                                           | 380,619           | 376,103              |
| Allowance for loan losses                                                                                               | (6,546)           | (6,495)              |
| Loans, net                                                                                                              | 374,073           | 369,608              |
| Premises and equipment, net                                                                                             | 8,226             | 8,282                |
| Bank-owned life insurance                                                                                               | 15,845            | 15,719               |
| Other real estate                                                                                                       | 7,081             | 7,292                |
| Other assets                                                                                                            | 21,101            | 20,443               |
| Total assets                                                                                                            | \$ 791,324        | \$ 773,382           |
| <b>Liabilities:</b>                                                                                                     |                   |                      |
| Deposits:                                                                                                               |                   |                      |
| Noninterest-bearing                                                                                                     | \$ 82,449         | \$ 76,497            |
| Interest-bearing                                                                                                        | 526,139           | 502,912              |
| Total deposits                                                                                                          | 608,588           | 579,409              |
| Federal funds purchased and securities sold under agreements to repurchase                                              | 2,407             | 15,960               |
| Long-term debt                                                                                                          | 118,345           | 118,349              |
| Accrued expenses and other liabilities                                                                                  | 4,206             | 3,481                |
| Total liabilities                                                                                                       | 733,546           | 717,199              |
| <b>Stockholders' equity:</b>                                                                                            |                   |                      |
| Preferred stock of \$.01 par value; authorized 200,000 shares; issued shares - none                                     |                   |                      |
| Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares                                   | 39                | 39                   |
| Additional paid-in capital                                                                                              | 3,751             | 3,751                |
| Retained earnings                                                                                                       | 59,823            | 58,917               |
| Accumulated other comprehensive income, net                                                                             | 800               | 111                  |
| Less treasury stock, at cost - 314,023 shares and 314,018 shares for March 31, 2010 and December 31, 2009, respectively | (6,635)           | (6,635)              |
| Total stockholders' equity                                                                                              | 57,778            | 56,183               |
| Total liabilities and stockholders' equity                                                                              | \$ 791,324        | \$ 773,382           |

See accompanying notes to condensed consolidated financial statements

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

|                                                                                                 | <b>Quarter ended March 31</b> |               |
|-------------------------------------------------------------------------------------------------|-------------------------------|---------------|
|                                                                                                 | <b>2010</b>                   | <b>2009</b>   |
| <i>(Dollars in thousands, except share and per share data)</i>                                  |                               |               |
| <b>Interest income:</b>                                                                         |                               |               |
| Loans, including fees                                                                           | \$ 5,433                      | \$ 5,346      |
| Securities                                                                                      | 3,219                         | 3,924         |
| Federal funds sold and interest bearing bank deposits                                           | 7                             | 6             |
| Total interest income                                                                           | 8,659                         | 9,276         |
| <b>Interest expense:</b>                                                                        |                               |               |
| Deposits                                                                                        | 2,640                         | 3,524         |
| Short-term borrowings                                                                           | 11                            | 16            |
| Long-term debt                                                                                  | 1,177                         | 1,211         |
| Total interest expense                                                                          | 3,828                         | 4,751         |
| <b>Net interest income</b>                                                                      | <b>4,831</b>                  | <b>4,525</b>  |
| <b>Provision for loan losses</b>                                                                | <b>1,450</b>                  | <b>550</b>    |
| <b>Net interest income after provision for loan losses</b>                                      | <b>3,381</b>                  | <b>3,975</b>  |
| <b>Noninterest income:</b>                                                                      |                               |               |
| Service charges on deposit accounts                                                             | 314                           | 303           |
| Mortgage lending                                                                                | 482                           | 1,330         |
| Bank-owned life insurance                                                                       | 126                           | 98            |
| Other                                                                                           | 324                           | 303           |
| Securities gains (losses), net:                                                                 |                               |               |
| Realized gains, net                                                                             | 1,100                         | 880           |
| Total other-than-temporary impairments                                                          | (240)                         | (3,003)       |
| Non-credit portion of other-than temporary impairments recognized in other comprehensive income | 190                           |               |
| Total securities gains (losses), net                                                            | 1,050                         | (2,123)       |
| Total noninterest income                                                                        | 2,296                         | (89)          |
| <b>Noninterest expense:</b>                                                                     |                               |               |
| Salaries and benefits                                                                           | 1,905                         | 2,049         |
| Net occupancy and equipment                                                                     | 384                           | 344           |
| Professional fees                                                                               | 176                           | 161           |
| FDIC and other regulatory assessments                                                           | 276                           | 197           |
| Other                                                                                           | 895                           | 802           |
| Total noninterest expense                                                                       | 3,636                         | 3,553         |
| <b>Earnings before income taxes</b>                                                             | <b>2,041</b>                  | <b>333</b>    |
| Income tax expense                                                                              | 424                           | 87            |
| <b>Net earnings</b>                                                                             | <b>\$ 1,617</b>               | <b>\$ 246</b> |
| <b>Net earnings per share:</b>                                                                  |                               |               |
| Basic and diluted                                                                               | \$ 0.44                       | \$ 0.07       |
| <b>Weighted average shares outstanding:</b>                                                     |                               |               |
| Basic and diluted                                                                               | 3,643,116                     | 3,646,827     |

See accompanying notes to condensed consolidated financial statements

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

|                                                                                                                                                  | <b>Common Stock</b> |               | <b>Additional</b> | <b>Retained</b> | <b>Accumulated</b>   | <b>Treasury</b> | <b>Total</b> |
|--------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|---------------|-------------------|-----------------|----------------------|-----------------|--------------|
|                                                                                                                                                  | <b>Shares</b>       | <b>Amount</b> | <b>paid-in</b>    | <b>earnings</b> | <b>other</b>         | <b>stock</b>    |              |
|                                                                                                                                                  |                     |               | <b>capital</b>    |                 | <b>comprehensive</b> |                 |              |
|                                                                                                                                                  |                     |               |                   |                 | <b>income (loss)</b> |                 |              |
| <i>(Dollars in thousands, except share and per share data)</i>                                                                                   |                     |               |                   |                 |                      |                 |              |
| <b>Balance, December 31, 2008</b>                                                                                                                | 3,957,135           | \$ 39         | \$ 3,749          | \$ 59,283       | \$ 603               | \$ (6,546)      | \$ 57,128    |
| Comprehensive income:                                                                                                                            |                     |               |                   |                 |                      |                 |              |
| Net earnings                                                                                                                                     |                     |               |                   | 246             |                      |                 | 246          |
| Other comprehensive loss due to change in unrealized gains (losses) on securities available-for-sale, net                                        |                     |               |                   |                 | (1,458)              |                 | (1,458)      |
| Total comprehensive loss                                                                                                                         |                     |               |                   | 246             | (1,458)              |                 | (1,212)      |
| Cash dividends paid (\$0.190 per share)                                                                                                          |                     |               |                   | (693)           |                      |                 | (693)        |
| Stock repurchases (2,055 shares)                                                                                                                 |                     |               |                   |                 |                      | (44)            | (44)         |
| Sale of treasury stock (65 shares)                                                                                                               |                     |               | 1                 |                 |                      |                 | 1            |
| <b>Balance, March 31, 2008</b>                                                                                                                   | 3,957,135           | \$ 39         | \$ 3,750          | \$ 58,836       | \$ (855)             | \$ (6,590)      | \$ 55,180    |
| <b>Balance, December 31, 2009</b>                                                                                                                | 3,957,135           | \$ 39         | \$ 3,751          | \$ 58,917       | \$ 111               | \$ (6,635)      | \$ 56,183    |
| Comprehensive income:                                                                                                                            |                     |               |                   |                 |                      |                 |              |
| Net earnings                                                                                                                                     |                     |               |                   | 1,617           |                      |                 | 1,617        |
| Other comprehensive loss due to change in other-than-temporary impairment losses related to factors other than credit on available-for-sale, net |                     |               |                   |                 | (120)                |                 | (120)        |
| Other comprehensive income due to change in all other unrealized gains (losses) on securities available-for-sale, net                            |                     |               |                   |                 | 809                  |                 | 809          |
| Total comprehensive income                                                                                                                       |                     |               |                   | 1,617           | 689                  |                 | 2,306        |
| Cash dividends paid (\$0.195 per share)                                                                                                          |                     |               |                   | (711)           |                      |                 | (711)        |
| Stock repurchases (25 shares)                                                                                                                    |                     |               |                   |                 |                      |                 |              |
| Sale of treasury stock (20 shares)                                                                                                               |                     |               |                   |                 |                      |                 |              |
| <b>Balance, March 31, 2010</b>                                                                                                                   | 3,957,135           | \$ 39         | \$ 3,751          | \$ 59,823       | \$ 800               | \$ (6,635)      | \$ 57,778    |

See accompanying notes to condensed consolidated financial statements

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

|                                                                                                       | <b>Quarter ended March 31</b> |                  |
|-------------------------------------------------------------------------------------------------------|-------------------------------|------------------|
|                                                                                                       | <b>2010</b>                   | <b>2009</b>      |
| <i>(In thousands)</i>                                                                                 |                               |                  |
| <b>Cash flows from operating activities:</b>                                                          |                               |                  |
| Net earnings                                                                                          | \$ 1,617                      | \$ 246           |
| Adjustments to reconcile net earnings to net cash provided by operating activities:                   |                               |                  |
| Provision for loan losses                                                                             | 1,450                         | 550              |
| Depreciation and amortization                                                                         | 133                           | 142              |
| Premium amortization and discount accretion, net                                                      | 442                           | 272              |
| Net (gain) loss on securities                                                                         | (1,050)                       | 2,123            |
| Net gain on sale of loans held for sale                                                               | (392)                         | (1,248)          |
| Net gain on sale of other real estate                                                                 | (37)                          | (33)             |
| Loans originated for sale                                                                             | (15,460)                      | (61,497)         |
| Proceeds from sale of loans                                                                           | 16,707                        | 63,060           |
| Increase in cash surrender value of bank owned life insurance                                         | (126)                         | (98)             |
| Net increase in other assets                                                                          | (1,064)                       | (1,807)          |
| Net increase (decrease) in accrued expenses and other liabilities                                     | 725                           | (393)            |
| Net cash provided by operating activities                                                             | 2,945                         | 1,317            |
| <b>Cash flows from investing activities:</b>                                                          |                               |                  |
| Proceeds from sales of securities available-for-sale                                                  | 59,994                        | 42,026           |
| Proceeds from maturities of securities available-for-sale                                             | 47,840                        | 24,985           |
| Purchase of securities available-for-sale                                                             | (105,033)                     | (126,170)        |
| Net increase in loans                                                                                 | (6,102)                       | (5,452)          |
| Net purchases of premises and equipment                                                               | (24)                          | (766)            |
| Proceeds from sale of other real estate                                                               | 435                           | 258              |
| Net cash used in investing activities                                                                 | (2,890)                       | (65,119)         |
| <b>Cash flows from financing activities:</b>                                                          |                               |                  |
| Net increase in noninterest-bearing deposits                                                          | 5,952                         | 1,994            |
| Net increase in interest-bearing deposits                                                             | 23,227                        | 56,369           |
| Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase | (13,553)                      | 463              |
| Repayments or retirement of long-term debt                                                            | (4)                           | (5)              |
| Purchase of treasury stock                                                                            |                               | (44)             |
| Stock repurchases                                                                                     |                               | 1                |
| Dividends paid                                                                                        | (711)                         | (693)            |
| Net cash provided by financing activities                                                             | 14,911                        | 58,085           |
| Net change in cash and cash equivalents                                                               | 14,966                        | (5,717)          |
| Cash and cash equivalents at beginning of period                                                      | 12,395                        | 36,433           |
| <b>Cash and cash equivalents at end of period</b>                                                     | <b>\$ 27,361</b>              | <b>\$ 30,716</b> |

**Supplemental disclosures of cash flow information:**

Cash paid during the period for:

|              |          |          |
|--------------|----------|----------|
| Interest     | \$ 4,048 | \$ 4,403 |
| Income taxes | 120      | 431      |

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

|                                          |     |    |
|------------------------------------------|-----|----|
| Real estate acquired through foreclosure | 187 | 13 |
|------------------------------------------|-----|----|

*See accompanying notes to condensed consolidated financial statements*





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

**Notes to the Condensed Consolidated Financial Statements**

**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 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 condensed consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The unaudited condensed 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 as of and for the nine months ended March 31, 2010, 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, 2009.

**Reclassifications**

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

**Subsequent Events**

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

**Current Accounting Developments**

Effective July 1, 2009, the Financial Accounting Standards Board (FASB) established the Accounting Standards Codification (ASC or the Codification) as the source of authoritative generally accepted accounting principles (GAAP) for companies to use in the preparation of financial statements. SEC rules and interpretive releases are also authoritative GAAP for SEC registrants. The guidance contained in the Codification supersedes all existing non-SEC accounting and reporting standards. The Company adopted the Codification, as required, in the third quarter of 2009. As a result, references to accounting literature contained in our financial statement disclosures have been updated to reflect the new Codification structure.

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

Accounting Standards Update (ASU) 2009-16, *Accounting for Transfers of Financial Assets* (SFAS No. 166, *Accounting for Transfers of Financial Assets* – an amendment of FASB Statement No. 140); and

ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*); and

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ASU 2010-6, *Improving Disclosures about Fair Value Measurements*.

ASU 2010-10, *Consolidation: Amendments for Certain Investment Funds*

Information about these pronouncements is described in more detail below.

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ASU 2009-16, *Accounting for Transfers of Financial Assets* (SFAS No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*), modifies certain guidance contained in FASB ASC 860, *Transfers and Servicing*. This standard eliminates the concept of qualifying special purpose entities (QSPEs) and provides additional criteria transferors must use to evaluate transfers of financial assets. To determine if a transfer is to be accounted for as a sale, the transferor must assess whether it and all of the entities included in its consolidated financial statements have surrendered control of the assets. A transferor must consider all arrangements or agreements made or contemplated at the time of transfer before reaching a conclusion on whether control has been relinquished. SFAS No. 166 addresses situations in which a portion of a financial asset is transferred. In such instances the transfer can only be accounted for as a sale when the transferred portion is considered to be a participating interest. SFAS No. 166 also requires that any assets or liabilities retained from a transfer accounted for as a sale be initially recognized at fair value. This standard is effective for the Company as of January 1, 2010, with adoption applied prospectively for transfers that occur on and after the effective date. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company.

ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*), amends several key consolidation provisions related to variable interest entities ( VIEs ), which are included in FASB ASC 810, *Consolidation*. First, the scope of FAS 167 includes entities that are currently designated as QSPEs. Second, FAS 167 changes the approach companies use to identify the VIEs for which they are deemed to be the primary beneficiary and are required to consolidate. Under existing rules, the primary beneficiary is the entity that absorbs the majority of a VIE's losses and receives the majority of the VIE's returns. The guidance in FAS 167 identifies a VIE's primary beneficiary as the entity that has the power to direct the VIE's significant activities, and has an obligation to absorb losses or the right to receive benefits that could be potentially significant to the VIE. Third, FAS 167 requires companies to continually reassess whether they are the primary beneficiary of a VIE. Existing rules only require companies to reconsider primary beneficiary conclusions when certain triggering events have occurred. SFAS No. 167 is effective for the Company as of January 1, 2010, and applies to all current QSPEs and VIEs, and VIEs created after the effective date. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company.

ASU 2010-6, *Improving Disclosures about Fair Value Measurements*, changes the disclosure requirements for fair value measurements. The Update requires expanded disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (ii) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. The Update further clarifies that (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) company's should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy will be required for the Corporation beginning January 1, 2011. The remaining disclosure requirements and clarifications in the Update became effective for the Company on January 1, 2010. Adoption did not affect the Company's consolidated financial results since it amended only the disclosure requirements for fair value measurements. See Note 7 of the Condensed Consolidated Financial Statements.

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

**Table of Contents****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 ended March 31, 2010 and 2009, respectively. Diluted net earnings per share reflect the potential dilution that could occur if the Company's potential common stock was issued. At March 31, 2010 and 2009, respectively, the Company had no options issued or outstanding.

A reconciliation of the numerator and denominator of the basic earnings per share computation to the diluted earnings per share computation for the quarter ended March 31, 2010 and 2009 are presented below.

| <i>(Dollars in thousands, except share and per share data)</i> | <b>Quarter ended March 31</b> |             |
|----------------------------------------------------------------|-------------------------------|-------------|
|                                                                | <b>2010</b>                   | <b>2009</b> |
| <b>Basic:</b>                                                  |                               |             |
| Net earnings                                                   | \$ 1,617                      | \$ 246      |
| Average common shares outstanding                              | 3,643,116                     | 3,646,827   |
| Earnings per share                                             | \$ 0.44                       | \$ 0.07     |
| <b>Diluted:</b>                                                |                               |             |
| Net earnings                                                   | \$ 1,617                      | \$ 246      |
| Average common shares outstanding                              | 3,643,116                     | 3,646,827   |
| Dilutive effect of options issued                              |                               |             |
| Average diluted shares outstanding                             | 3,643,116                     | 3,646,827   |
| Earnings per share                                             | \$ 0.44                       | \$ 0.07     |

**NOTE 3: COMPREHENSIVE INCOME**

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

| <i>(In thousands)</i>                                                                                                              | <b>Quarter ended March 31</b> |             |
|------------------------------------------------------------------------------------------------------------------------------------|-------------------------------|-------------|
|                                                                                                                                    | <b>2010</b>                   | <b>2009</b> |
| <b>Comprehensive income:</b>                                                                                                       |                               |             |
| Net earnings                                                                                                                       | \$ 1,617                      | \$ 246      |
| <b>Other comprehensive income (loss):</b>                                                                                          |                               |             |
| Due to change in other-than-temporary impairment losses related to factors other than credit on securities available-for-sale, net | (120)                         |             |
| Due to change in all other unrealized gains (losses) on securities available-for-sale, net                                         | 809                           | (1,458)     |
| Total comprehensive income (loss)                                                                                                  | \$ 2,306                      | \$ (1,212)  |

**NOTE 4: VARIABLE INTEREST ENTITIES**

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

The Company owns the common stock of subsidiary business trusts, which have issued mandatorily redeemable preferred capital securities ( trust preferred securities ) in the aggregate of approximately \$7.2 million at the time of issuance. These trusts meet the definition of a VIE of

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which the Company is not the primary beneficiary; the trusts' only assets are junior subordinated debentures issued by the Company, which were acquired by the trusts using the proceeds from the issuance of the trust preferred securities and common stock. The junior subordinated debentures are included in long-term debt and the Company's equity interests in the business trusts are included in other assets. Interest expense on the junior subordinated debentures is reported in interest expense on long-term debt. For regulatory reporting and capital adequacy purposes, the Federal Reserve Board has indicated that such trust preferred securities will continue to constitute Tier 1 Capital until

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further notice.

Periodically, the Company may invest in various limited partnerships that sponsor affordable housing projects in its primary markets and surrounding areas as a means of supporting local communities. These investments are designed to generate a return primarily through the realization of federal tax credits. These projects are funded through a combination of debt and equity and the partnerships meet the definition of a VIE. While the Company's investment in a single entity may at times exceed 50% of the outstanding equity interests, the Company does not consolidate the partnerships due to the nature of the management activities of the general partner and the performance guaranties provided by the project sponsors giving them the majority of the variability. The Company typically provides financing during the construction and development of the properties; however, permanent financing is generally obtained from independent parties upon completion of a project. As of March 31, 2010 and December 31, 2009, the Company had investments of \$1.8 million and \$0.3 million, respectively, related to these projects, which are included in other assets on the Consolidated Balance Sheets. As of March 31, 2010, the Company had \$0.7 million in unfunded commitments related to affordable housing investments included in other liabilities. The Company had no unfunded commitments related to affordable housing investments included in other liabilities at December 31, 2009. Additionally, the Company had outstanding loan commitments with certain of the partnerships totaling \$11.4 million at March 31, 2010 and December 31, 2009, respectively. The funded portion of these loans was approximately \$0.8 million at March 31, 2010. There was no funded portion for any of the outstanding loan commitments with certain of the partnerships at December 31, 2009. The funded portions of these loans are included in loans, net of unearned income on the Consolidated Balance Sheets.

**NOTE 5: SECURITIES**

At March 31, 2010 and December 31, 2009, all securities within the scope of FASB ASC 320, *Investments—Debt and Equity Securities* (SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*) were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale at March 31, 2010 and December 31, 2009, by contractual maturity are presented below.

|                                  | March 31, 2010   |               |                |                |              |                        |                   |
|----------------------------------|------------------|---------------|----------------|----------------|--------------|------------------------|-------------------|
|                                  | 1 year or less   | 10 to 5 years | 5 to 10 years  | After 10 years | Fair Value   | Gross Unrealized Gains | Unrealized Losses |
| (Dollars in thousands)           |                  |               |                |                |              |                        |                   |
| <b>Available-for-sale:</b>       |                  |               |                |                |              |                        |                   |
| Agency obligations (a)           | \$ 34,407        | 42,795        | 49,998         | 127,200        | 665          | 138                    | 126,673           |
| Agency RMBS (a)                  |                  |               | 119,626        | 119,626        | 2,696        | 166                    | 117,096           |
| State and political subdivisions | 472              | 14,425        | 67,393         | 82,290         | 1,326        | 478                    | 81,442            |
| Trust preferred securities:      |                  |               |                |                |              |                        |                   |
| Pooled                           |                  |               | 40             | 40             |              | 190                    | 230               |
| Individual issuer                |                  |               | 1,560          | 1,560          |              | 1,890                  | 3,450             |
| Corporate debt                   | 2,180            | 764           |                | 2,944          |              | 557                    | 3,501             |
| <b>Total available-for-sale</b>  | <b>\$ 37,059</b> | <b>57,984</b> | <b>238,617</b> | <b>333,660</b> | <b>4,687</b> | <b>3,419</b>           | <b>332,392</b>    |

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

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

(a) Includes securities issued by U.S. government agencies or government sponsored entities. Securities with aggregate fair values of \$215.6 million and \$203.4 million at March 31, 2010 and December 31, 2009, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank ( FHLB ) advances, and for other purposes required or permitted by law.

Included in other assets are cost-method investments. The carrying amounts of cost-method investments were \$6.0 million at March 31, 2010 and December 31, 2009, respectively. Cost-method investments primarily include Federal Home Loan Bank ( FHLB ) of Atlanta stock and Federal Reserve Bank stock.

## Gross Unrealized Losses and Fair Value

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

|                                  | Less than 12 months |            | 12 months or longer |              | Total         |              |
|----------------------------------|---------------------|------------|---------------------|--------------|---------------|--------------|
|                                  | Fair                | Unrealized | Fair                | Unrealized   | Fair          | Unrealized   |
| (Dollars in thousands)           | Value               | Losses     | Value               | Losses       | Value         | Losses       |
| <b>March 31, 2010:</b>           |                     |            |                     |              |               |              |
| Agency obligations               | \$ 22,350           | 55         | 9,178               | 83           | 31,528        | 138          |
| Agency RMBS                      | 23,077              | 166        |                     |              | 23,077        | 166          |
| State and political subdivisions | 15,393              | 285        | 2,870               | 193          | 18,263        | 478          |
| Trust preferred securities:      |                     |            |                     |              |               |              |
| Pooled                           |                     |            | 40                  | 190          | 40            | 190          |
| Individual issuer                |                     |            | 1,560               | 1,890        | 1,560         | 1,890        |
| Corporate debt                   |                     |            | 2,944               | 557          | 2,944         | 557          |
| <b>Total</b>                     | <b>\$ 60,820</b>    | <b>506</b> | <b>16,592</b>       | <b>2,913</b> | <b>77,412</b> | <b>3,419</b> |
| <b>December 31, 2009:</b>        |                     |            |                     |              |               |              |
| Agency obligations               | \$ 46,219           | 630        |                     |              | 46,219        | 630          |
| Agency RMBS                      | 48,343              | 380        |                     |              | 48,343        | 380          |
| State and political subdivisions | 18,868              | 351        | 2,837               | 227          | 21,705        | 578          |
| Trust preferred securities:      |                     |            |                     |              |               |              |
| Pooled                           | 13                  | 37         | 10                  | 220          | 23            | 257          |
| Individual issuer                |                     |            | 1,440               | 2,010        | 1,440         | 2,010        |
| Corporate debt                   |                     |            | 2,876               | 626          | 2,876         | 626          |

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|       |            |       |       |       |         |       |
|-------|------------|-------|-------|-------|---------|-------|
| Total | \$ 113,443 | 1,398 | 7,163 | 3,083 | 120,606 | 4,481 |
|-------|------------|-------|-------|-------|---------|-------|

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



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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. The Company has assessed each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities' amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

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

the length of time and the extent to which the fair value has been less than the amortized cost basis;

adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);

the historical and implied volatility of the fair value of the security;

the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;

failure of the issuer of the security to make scheduled interest or principal payments;

any changes to the rating of the security by a rating agency; and

recoveries or additional declines in fair value subsequent to the balance sheet date.

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

remaining payment terms of the security (including as applicable, terms that require underlying obligor payments to increase in the future);

current delinquencies and nonperforming assets of underlying collateral;

expected future default rates;

subordination levels or other credit enhancements.

### *Agency obligations*

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

*Agency residential mortgage-backed securities ( RMBS )*

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

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

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

*Pooled trust preferred securities*

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

**Table of Contents***Individual issuer trust preferred securities*

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

*Corporate debt securities*

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

*Cost-method investments*

At March 31, 2010, cost-method investments with an aggregate cost of \$6.0 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

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

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

**Trust Preferred Securities as of March 31, 2010**

|                                         | Credit Rating |         | Unrealized losses  |                   |            | Life-to-date |
|-----------------------------------------|---------------|---------|--------------------|-------------------|------------|--------------|
|                                         |               |         | Less than12 months |                   | Impairment |              |
|                                         | Moody         | s Fitch | Fair valued        | 2 monthsor longer | Total      | Charges      |
| (Dollars in thousands)                  |               |         |                    |                   |            |              |
| Pooled:                                 |               |         |                    |                   |            |              |
| ALESCO Preferred Funding XVII, Ltd. (a) | Ca            | CC      | \$ 40              | \$ 190            | 190        | \$ 1,770     |
| Individual issuer (b):                  |               |         |                    |                   |            |              |
| Carolina Financial Capital Trust I      | n/a           | n/a     | 135                | 315               | 315        |              |
| Main Street Bank Statutory Trust I (c)  | n/a           | n/a     | 300                | 200               | 200        |              |
| MNB Capital Trust I                     | n/a           | n/a     | 100                | 400               | 400        |              |
| PrimeSouth Capital Trust I              | n/a           | n/a     | 125                | 375               | 375        |              |
| TCB Trust                               | n/a           | n/a     | 250                | 250               | 250        |              |
| United Community Capital Trust          | n/a           | n/a     | 650                | 350               | 350        |              |
| Total individual issuer                 |               |         | 1,560              | 1,890             | 1,890      |              |
| Total trust preferred securities        |               |         | \$ 1,600           | \$ 2,080          | 2,080      | \$ 1,770     |

n/a - not applicable, securities not rated.

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

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

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

n/a - not applicable, securities not rated.

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

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

Excess subordination is defined as the amount of performing collateral that is in excess of what is needed to payoff a specified class of securities and all classes senior to the specified class. Performing collateral is defined as total collateral minus all collateral that is currently deferring or currently in default. This definition assumes that all collateral that is currently deferring will default with a zero recovery rate. The underlying issuers can cure, or the bonds could recover a higher percentage upon default than zero. Excess subordination, as defined previously, does not consider any excess interest spread that is built into the structure of the security, which provides another source of repayment for the bonds.

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At March 31, 2010 and December 31, 2009, respectively, there was no excess subordination for both the Class B notes of ALESCO Preferred Funding XVII, Ltd. and the B-2 notes of U.S. Capital Funding IV, Ltd.

### **Other-Than-Temporarily Impaired Securities**

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

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be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses).

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

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and the credit component of the loss is recognized in earnings (referred to as credit-impaired debt securities). Other-than-temporary impairments recognized in earnings for the quarter ended March 31, 2010 and 2009 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 or the security matures. Changes in the credit loss component of credit-impaired debt securities were:

|                                                        | Quarter ended March 31 |          |
|--------------------------------------------------------|------------------------|----------|
|                                                        | 2010                   | 2009     |
| <i>(Dollars in thousands)</i>                          |                        |          |
| Balance, beginning of period                           | \$ 4,570               | \$       |
| Additions:                                             |                        |          |
| Initial credit impairments                             |                        | 1,688    |
| Subsequent credit impairments                          | 50                     |          |
| Reductions:                                            |                        |          |
| Securities sold                                        |                        |          |
| Due to change in intent to sell or requirement to sell |                        |          |
| Increases in expected cash flows                       |                        |          |
| Balance, end of period                                 | \$ 4,620               | \$ 1,688 |

**Table of Contents****Other-Than-Temporary Impairment**

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

| <i>(Dollars in thousands)</i>                                                     | <b>Quarter ended March 31</b> |             |
|-----------------------------------------------------------------------------------|-------------------------------|-------------|
|                                                                                   | <b>2010</b>                   | <b>2009</b> |
| <b>Other-than-temporary impairment charges (included in earnings):</b>            |                               |             |
| Debt securities:                                                                  |                               |             |
| Pooled trust preferred securities                                                 | \$ 50                         | \$          |
| Individual issuer trust preferred securities                                      |                               | 1,688       |
| Total debt securities                                                             | 50                            | 1,688       |
| Cost-method investments                                                           |                               | 1,315       |
| Total other-than-temporary impairment charges                                     | \$ 50                         | \$ 3,003    |
| <b>Other-than-temporary impairment on debt securities:</b>                        |                               |             |
| Recorded as part of gross realized losses:                                        |                               |             |
| Credit-related                                                                    | \$ 50                         | \$ 1,688    |
| Securities with intent to sell                                                    |                               |             |
| Recorded directly to other comprehensive income for non-credit related impairment | 190                           |             |
| Total other-than-temporary impairment on debt securities                          | \$ 240                        | \$ 1,688    |

**Realized Gains and Losses**

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

| <i>(Dollars in thousands)</i> | <b>Quarter ended March 31</b> |             |
|-------------------------------|-------------------------------|-------------|
|                               | <b>2010</b>                   | <b>2009</b> |
| Gross realized gains          | \$ 1,139                      | \$ 880      |
| Gross realized losses         | (89)                          | (3,003)     |
| Net realized gains (losses)   | \$ 1,050                      | \$ (2,123)  |

**NOTE 6: MORTGAGE SERVICING RIGHTS, NET**

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

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





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The change in amortized MSRs and the related valuation allowance for the quarter ended March 31, 2010 and 2009 are presented below.

| (Dollars in thousands)        | Quarter ended March 31 |        |
|-------------------------------|------------------------|--------|
|                               | 2010                   | 2009   |
| Beginning Balance             | \$ 834                 | \$     |
| Additions                     | 49                     | 266    |
| Amortization expense          | (32)                   |        |
| Change in valuation allowance |                        |        |
| Ending Balance                | \$ 851                 | \$ 266 |

**Fair value of amortized MSRs:**

|                     |           |
|---------------------|-----------|
| Beginning of period | 978       |
| End of period       | 1,030 295 |

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

**NOTE 7: FAIR VALUE DISCLOSURES**

Fair value is defined by FASB ASC 820, *Fair Value Measurements and Disclosures*, (SFAS No. 157, *Fair Value Measurements*) as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FASB ASC 820 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

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

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

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

The Company's assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy in accordance with FASB ASC 820. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Corporation's monthly and/or quarterly valuation process.

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

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

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Security fair value measurements using significant inputs that are unobservable in the market due to limited activity or a less liquid market are classified within Level 3 of the valuation hierarchy. Such measurements include securities valued using models or a combination of valuation techniques such as weighting of models and vendor or broker pricing, where the unobservable inputs are significant to the overall fair value measurement. Securities classified as Level 3 include pooled and individual issuer trust preferred securities.

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

*Loans, net* Loans considered impaired under FASB ASC 310-10-35, *Receivables* (SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by SFAS No. 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosure*) are loans for which, based on current information and events, it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are subject to nonrecurring fair value adjustments to reflect (1) partial write-downs that are based on the observable market price or current appraised value of the collateral, or (2) the full charge-off of the loan carrying value. All of the Company's impaired loans are classified within Level 3 of the valuation hierarchy.

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

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

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

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

**Table of Contents****Assets and liabilities measured at fair value on a recurring basis**

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of March 31, 2010 and December 31, 2009, respectively, by caption, on the consolidated balance sheets by FASB ASC 820 valuation hierarchy (as described above). There were no significant transfers of assets or liabilities into or out of Level 1, Level 2, or Level 3 of the fair value hierarchy during the quarter ended March 31, 2010.

| <i>(Dollars in thousands)</i>          | <b>Amount</b>     | <b>Quoted Prices in<br/>Active Markets<br/>for<br/>Identical Assets<br/>(Level 1)</b> | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> |
|----------------------------------------|-------------------|---------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|
| <b>March 31, 2010:</b>                 |                   |                                                                                       |                                                                      |                                                              |
| Securities available-for-sale:         |                   |                                                                                       |                                                                      |                                                              |
| Agency obligations                     | \$ 127,200        |                                                                                       | 127,200                                                              |                                                              |
| Agency RMBS                            | 119,626           |                                                                                       | 119,626                                                              |                                                              |
| States and political subdivisions      | 82,290            |                                                                                       | 82,290                                                               |                                                              |
| Trust preferred securities:            |                   |                                                                                       |                                                                      |                                                              |
| Pooled                                 | 40                |                                                                                       |                                                                      | 40                                                           |
| Individual issuer                      | 1,560             |                                                                                       |                                                                      | 1,560                                                        |
| Corporate debt                         | 2,944             |                                                                                       | 2,944                                                                |                                                              |
| Total securities available-for-sale    | 333,660           |                                                                                       | 332,060                                                              | 1,600                                                        |
| Other assets <sup>(1)</sup>            | 989               |                                                                                       | 989                                                                  |                                                              |
| <b>Total assets at fair value</b>      | <b>\$ 334,649</b> |                                                                                       | <b>333,049</b>                                                       | <b>1,600</b>                                                 |
|                                        |                   |                                                                                       |                                                                      |                                                              |
| Other liabilities <sup>(1)</sup>       | \$ 989            |                                                                                       | 989                                                                  |                                                              |
| <b>Total liabilities at fair value</b> | <b>\$ 989</b>     |                                                                                       | <b>989</b>                                                           |                                                              |
| <b>December 31, 2009:</b>              |                   |                                                                                       |                                                                      |                                                              |
| Securities available-for-sale:         |                   |                                                                                       |                                                                      |                                                              |
| Agency obligations                     | \$ 90,220         |                                                                                       | 90,220                                                               |                                                              |
| Agency RMBS                            | 158,642           |                                                                                       | 158,642                                                              |                                                              |
| States and political subdivisions      | 81,562            |                                                                                       | 81,562                                                               |                                                              |
| Trust preferred securities:            |                   |                                                                                       |                                                                      |                                                              |
| Pooled                                 | 23                |                                                                                       |                                                                      | 23                                                           |
| Individual issuer                      | 1,440             |                                                                                       |                                                                      | 1,440                                                        |
| Corporate debt                         | 2,875             |                                                                                       | 2,875                                                                |                                                              |
| Total securities available-for-sale    | 334,762           |                                                                                       | 333,299                                                              | 1,463                                                        |
| Other assets <sup>(1)</sup>            | 931               |                                                                                       | 931                                                                  |                                                              |
| <b>Total assets at fair value</b>      | <b>\$ 335,693</b> |                                                                                       | <b>334,230</b>                                                       | <b>1,463</b>                                                 |
|                                        |                   |                                                                                       |                                                                      |                                                              |
| Other liabilities <sup>(1)</sup>       | \$ 931            |                                                                                       | 931                                                                  |                                                              |
| <b>Total liabilities at fair value</b> | <b>\$ 931</b>     |                                                                                       | <b>931</b>                                                           |                                                              |

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

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

| (Dollars in thousands)                            | Quarter ended March 31 |          |
|---------------------------------------------------|------------------------|----------|
|                                                   | 2010                   | 2009     |
| Beginning balance                                 | \$ 1,463               | \$ 8,705 |
| Total realized and unrealized gains and (losses): |                        |          |
| Included in net earnings                          | (50)                   | (1,688)  |
| Included in other comprehensive income            | 187                    | (1,621)  |
| Purchases, issuances and settlements              |                        |          |
| Transfers in and/or (out) of Level 3              |                        | (2,613)  |
| Ending balance                                    | \$ 1,600               | \$ 2,783 |

There were no transfers in and/or (out) of Level 3 for financial assets during the quarter ended March 31, 2010. The transfer from Level 3 to Level 2 during the quarter ended March 31, 2009 primarily related to corporate debt securities. Due to an increase in trading activity and observable inputs for the Company's corporate debt securities during the quarter ended March 31, 2009, the fair value measurements for these securities were recognized using Level 2 inputs as of March 31, 2009.

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

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

| (Dollars in thousands)            | Amount           | Active Markets for |                         | Significant Unobservable Inputs |
|-----------------------------------|------------------|--------------------|-------------------------|---------------------------------|
|                                   |                  | Identical Assets   | Other Observable Inputs |                                 |
|                                   |                  | (Level 1)          | (Level 2)               | (Level 3)                       |
| <b>March 31, 2010:</b>            |                  |                    |                         |                                 |
| Loans held for sale               | \$ 3,977         |                    | 3,977                   |                                 |
| Loans, net <sup>(1)</sup>         | 9,544            |                    |                         | 9,544                           |
| Other real estate owned           | 7,081            |                    |                         | 7,081                           |
| Other assets <sup>(2)</sup>       | 851              |                    |                         | 851                             |
| <b>Total assets at fair value</b> | <b>\$ 21,453</b> |                    | <b>3,977</b>            | <b>17,476</b>                   |
| <b>December 31, 2009:</b>         |                  |                    |                         |                                 |
| Loans held for sale               | \$ 4,881         |                    | 4,881                   |                                 |
| Loans, net <sup>(1)</sup>         | 8,430            |                    |                         | 8,430                           |
| Other real estate owned           | 7,292            |                    |                         | 7,292                           |
| Other assets <sup>(2)</sup>       | 834              |                    |                         | 834                             |
| <b>Total assets at fair value</b> | <b>\$ 21,437</b> |                    | <b>4,881</b>            | <b>16,556</b>                   |

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

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

**NOTE 8: FAIR VALUE OF FINANCIAL INSTRUMENTS**

FASB ASC 825, *Financial Instruments*, (SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*) requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate

that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow and other valuation techniques. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent markets and should not be considered representative of the liquidation value

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of the Company's financial instruments, but rather a good faith estimate of the fair value of financial instruments held by the Company. FASB ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

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

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

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

### ***Securities***

Fair value measurement is based upon quoted prices if available. If quoted market prices are not available, estimated fair values are based on quoted market prices of comparable instruments. See Note 5 for additional disclosure related to fair value measurements for securities.

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

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

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

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

### ***Deposits***

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

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

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

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

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

### ***Derivative Instruments***

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

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

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The fair values of the Company's off-balance-sheet financial instruments are based on fees charged to enter into similar agreements. However, commitments to extend credit do not represent a significant value to the Company until



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such commitments are funded. The Company has determined that the estimated fair value of commitments to extend credit approximates the carrying amount and is immaterial to the financial statements.

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

|                               | March 31, 2010  |                      | December 31, 2009 |                      |
|-------------------------------|-----------------|----------------------|-------------------|----------------------|
|                               | Carrying amount | Estimated fair value | Carrying amount   | Estimated fair value |
| <i>(Dollars in thousands)</i> |                 |                      |                   |                      |
| <b>Financial Assets:</b>      |                 |                      |                   |                      |
| Cash and cash equivalents     | \$ 27,361       | \$ 27,361            | \$ 12,395         | \$ 12,395            |
| Securities                    | 333,660         | 333,660              | 334,762           | 334,762              |
| Loans held for sale           | 3,977           | 3,977                | 4,881             | 4,881                |
| Loans, net                    | 374,073         | 378,437              | 369,608           | 373,940              |
| Derivative assets             | 989             | 989                  | 931               | 931                  |
| <b>Financial Liabilities:</b> |                 |                      |                   |                      |
| Deposits                      | \$ 608,588      | \$ 614,996           | \$ 579,409        | \$ 585,597           |
| Short-term borrowings         | 2,407           | 2,407                | 15,960            | 15,960               |
| Long-term debt                | 118,345         | 124,628              | 118,349           | 124,004              |
| Derivative liabilities        | 989             | 989                  | 931               | 931                  |

**NOTE 9: DERIVATIVE INSTRUMENTS**

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current earnings. From time to time, the Company may enter into interest rate swaps ( swaps ) to facilitate customer transactions and meet their financing needs. Upon entering into these instruments to meet customer needs, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At March 31, 2010 the Company had no derivative contracts to assist in managing interest rate sensitivity.

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

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

|                                       | Notional  | Other Assets<br>Estimated<br>Fair Value | Other Liabilities<br>Estimated<br>Fair Value | Other noninterest<br>income<br>Gains<br>(Losses) |
|---------------------------------------|-----------|-----------------------------------------|----------------------------------------------|--------------------------------------------------|
| <i>(Dollars in thousands)</i>         |           |                                         |                                              |                                                  |
| <b>Interest rate swap agreements:</b> |           |                                         |                                              |                                                  |
| Pay fixed / receive variable          | \$ 6,329  | \$                                      | \$ 989                                       | \$ (58)                                          |
| Pay variable / receive fixed          | 6,329     | 989                                     |                                              | 58                                               |
| Total interest rate swap agreements   | \$ 12,658 | \$ 989                                  | \$ 989                                       | \$                                               |

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

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 quarters ended March 31, 2010 and 2009, as well as the information contained in our annual report on Form 10-K for the year ended December 31, 2009.

Certain of the statements made herein under the caption MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, 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 our actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by such 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, desired, indicate, would, believe, contemplate, expect, seek, estimate, evaluate, continue, plan, point to, project, predict, could, intend, target, potential, and expressions of the future. These 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, 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;

changes in borrower credit risks and payment behaviors;

changes in the availability and cost of credit and capital in the financial markets;

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

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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

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, 2009 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 is a one-bank holding company established in 1984, and incorporated under the laws of the State of Delaware. 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 in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, Hurtsboro and Notasulga, Alabama. In-store branches are located in the Auburn and Opelika Kroger stores, as well as Wal-Mart SuperCenter stores in Auburn, Opelika and Phenix City, Alabama. Mortgage loan offices are located in Phenix City, Valley, and Mountain Brook, Alabama.

**Summary of Results of Operations**

| <i>(Dollars in thousands, except per share amounts)</i> | Quarter ended March 31 |          |
|---------------------------------------------------------|------------------------|----------|
|                                                         | 2010                   | 2009     |
| Net interest income (a)                                 | \$ 5,268               | \$ 4,884 |
| Less: tax-equivalent adjustment                         | 437                    | 359      |
| Net interest income (GAAP)                              | 4,831                  | 4,525    |
| Noninterest income (loss)                               | 2,296                  | (89)     |
| Total revenue                                           | 7,127                  | 4,436    |
| Provision for loan losses                               | 1,450                  | 550      |
| Noninterest expense                                     | 3,636                  | 3,553    |
| Income tax expense                                      | 424                    | 87       |
| Net earnings                                            | \$ 1,617               | \$ 246   |
| Basic and diluted earnings per share                    | \$ 0.44                | \$ 0.07  |

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

**Financial Summary**

The Company's net earnings were \$1.6 million for the first quarter of 2010 compared to \$0.2 million for the first quarter of 2009. Basic and diluted earnings per share were \$0.44 per share for the first quarter of 2010 compared to \$0.07 per share for the first quarter of 2009.

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Net interest income (tax-equivalent) was approximately \$5.3 million for the first quarter of 2010, compared to \$4.9 million from the first quarter of 2009. Average loans were \$379.1 million in the first quarter of 2010, an increase of \$6.4 million, or 2%, from the first quarter of 2009. Average deposits were \$599.0 million in the first quarter of 2010, an increase of \$18.1million, or 3%, from the first quarter of 2009.

Credit quality deteriorated in the first quarter of 2010, when compared to the first quarter of 2009, due to continued economic stress. Although the Company's level of net-charge offs and nonperforming assets compare favorably to peers, the Company experienced an increase in both measures during the first quarter of 2010. The Company's annualized net

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charge-off ratio was 1.48% in the first quarter of 2010 from, compared to 0.45% in the first quarter of 2009. The increase in net charge-offs was primarily due to deterioration in the Company's construction and land development portfolio. Nonperforming assets were 2.28% of total assets at March 31, 2010, compared to 2.15% at December 31, 2009. Although the majority of the balance in nonperforming assets at March 31, 2010 related to the construction and land development loan portfolio, the increase in nonperforming assets from December 31, 2009 was primarily due to loans secured by residential real estate. Continued weakness in the real estate market and the overall economy adversely affected the Company's volume of nonperforming assets during the first quarter of 2010, and these economic conditions are expected to persist for the foreseeable future. The provision for loan losses for the first quarter of 2010 was \$1.5 million compared to \$0.6 million in the first quarter of 2009. The increase in provision for loan losses reflects increases in the overall level of risk within the loan portfolio, past due and nonperforming loans, and increases in net-charge offs during the first quarter of 2010 when compared to the first quarter of 2009.

Noninterest income was approximately \$2.3 million for the first quarter of 2010, compared to a loss of approximately \$0.1 million in the first quarter 2009. The increase in total noninterest income is primarily due to a decrease in other-than-temporary impairment charges, reflected within net securities gains (losses). Net securities gains (losses) included approximately \$0.1 million of other-than-temporary impairment charges in the first quarter of 2010, compared to approximately \$3.0 million in other-than-temporary impairment charges recognized in the first quarter of 2009. Other-than-temporary impairment charges recognized in earnings during the first quarter of 2009 primarily related to the Company's investments in the common stock and trust preferred securities related to Silverton Financial Services, Inc.

Noninterest expense was approximately \$3.6 million during the first quarter of 2010 and 2009. Increases in FDIC and other regulatory assessments expense and other noninterest expense were largely offset by decreases in salaries and benefits expense. The decrease in salaries and benefits expense was primarily attributable to a decrease in commissions paid to our mortgage originators as a result of decreased origination volume in the first quarter of 2010 compared to the first quarter of 2009.

In the first quarter of 2010, the Company paid cash dividends of \$0.7 million, or \$0.195 per share. The Company's balance sheet remains strong and well capitalized under regulatory guidelines with a total risk-based capital ratio of 15.01% and a tier 1 leverage ratio of 8.17% at March 31, 2010.

## **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, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

### **Allowance for Loan Losses**

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

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

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

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

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

As part of the Company's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial loans (including financial and agricultural loans), construction and land development loans, mortgage loans secured by commercial real estate, mortgage loans secured by residential real estate, and consumer 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.

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

The Company maintains an unallocated amount for inherent factors that cannot be practically assigned to individual loan segments or categories. An example is the imprecision in the overall measurement process, in particular the volatility of the national and local economy.

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

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

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the entity will be required to sell the debt security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference





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

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

### **Fair Value Determination**

GAAP requires management to value and present at fair value certain of the Company's assets and liabilities, including investments classified as available-for-sale and derivatives. FASB ASC 820, *Fair Value Measurements and Disclosures*, (SFAS No. 157, *Fair Value Measurements*), which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 7 of the Condensed Consolidated Financial Statements.

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

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

### **Other Real Estate Owned**

Other real estate owned (OREO), consists of properties obtained through foreclosure or in satisfaction of loans, is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal realized at the time of disposal are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of other real estate owned, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility, as experienced during 2009. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other real estate owned.

### **Deferred Tax Asset Valuation**

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

**Table of Contents****RESULTS OF OPERATIONS****Average Balance Sheet and Interest Rates**

|                                                                       | Quarter ended March 31 |                |                    |                |
|-----------------------------------------------------------------------|------------------------|----------------|--------------------|----------------|
|                                                                       | 2010                   |                | 2009               |                |
|                                                                       | Average<br>Balance     | Yield/<br>Rate | Average<br>Balance | Yield/<br>Rate |
| <i>(Dollars in thousands)</i>                                         |                        |                |                    |                |
| Loans and loans held for sale                                         | \$ 381,784             | 5.77%          | \$ 377,560         | 5.74%          |
| Securities - taxable                                                  | 250,286                | 3.84%          | 272,370            | 4.80%          |
| Securities - tax-exempt                                               | 80,812                 | 6.47%          | 66,065             | 6.48%          |
| Total securities                                                      | 331,098                | 4.48%          | 338,435            | 5.13%          |
| Federal funds sold                                                    | 12,832                 | 0.22%          | 11,256             | 0.22%          |
| Interest bearing bank deposits                                        | 1,076                  | 0.00%          | 918                | 0.00%          |
| Total interest-earning assets                                         | 726,790                | 5.08%          | 728,169            | 5.37%          |
| Deposits:                                                             |                        |                |                    |                |
| NOW                                                                   | 93,348                 | 0.76%          | 86,417             | 0.98%          |
| Savings and money market                                              | 104,334                | 1.12%          | 88,960             | 1.24%          |
| Certificates of deposits less than \$100,000                          | 150,912                | 2.42%          | 143,143            | 3.23%          |
| Certificates of deposits and other time deposits of \$100,000 or more | 166,961                | 3.10%          | 188,047            | 4.11%          |
| Total interest-bearing deposits                                       | 515,555                | 2.08%          | 506,567            | 2.82%          |
| Short-term borrowings                                                 | 6,256                  | 0.71%          | 12,799             | 0.51%          |
| Long-term debt                                                        | 118,347                | 4.03%          | 123,365            | 3.98%          |
| Total interest-bearing liabilities                                    | 640,158                | 2.43%          | 642,731            | 3.00%          |
| Net interest income and margin                                        | \$ 5,268               | 2.94%          | \$ 4,884           | 2.72%          |

**Net Interest Income and Margin**

Net interest income (tax-equivalent) increased 8% in the first quarter of 2010 from the first quarter of 2009 as a result of net interest margin expansion. Net interest margin (tax-equivalent) was 2.94% for the first quarter of 2010, compared to 2.72% for the first quarter of 2009.

The tax-equivalent yield on total interest earning assets decreased 29 basis points in the first quarter of 2010 from the first quarter of 2009 to 5.08%. This decrease was primarily driven by a 65 basis point decrease in the tax-equivalent yield on total securities to 4.48%.

The cost of total interest-bearing liabilities decreased 57 basis points in the first quarter of 2010 from the first quarter of 2009, to 2.43%. This decrease was primarily driven by a 74 basis point decrease in the cost of total interest-bearing deposits to 2.08%.

**Provision for Loan Losses**

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the probable losses on outstanding loans. The provision for loan losses amounted to \$1,450,000 and \$550,000 for the quarters ended March 31, 2010 and 2009, respectively.

The increase in the provision for loan losses reflects increases in the overall level of risk within the loan portfolio, past due and nonperforming loans, and increases in net-charge offs during the first quarter of 2010 when compared to the first quarter of 2009. The impact of continuing economic distress, specifically its impact on our construction and land development loan portfolio, contributed to the significant increase in the provision for loan losses in the first quarter of 2010 when compared to the first quarter of 2009. The construction and land development loan

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portfolio has experienced weakness due to continued decreased real estate sales which has led to falling appraisal values of the collateral which secures the Company's construction and land development loan portfolio. The Company's collateral for construction and land development loans is generally the primary source of repayment. As the value of the collateral deteriorates, ultimate repayment by the borrower becomes increasingly difficult. As a result, the Company has increased its allowance for loan

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losses which has led to increased provision for loan losses in the first quarter of 2010 when compared to the first quarter of 2009.

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes should be appropriate to adequately cover probable losses in the loan portfolio. The Company's allowance for loan losses as a percentage of total loans was 1.72% at March 31, 2010, compared to 1.73% at December 31, 2009. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2009. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management and are reviewed from time to time by our regulators, they are necessarily approximate and imprecise. There exist factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions which may have a material adverse effect on our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

**Noninterest Income**

|                                     | Quarter ended March 31 |         |
|-------------------------------------|------------------------|---------|
|                                     | 2010                   | 2009    |
| <i>(Dollars in thousands)</i>       |                        |         |
| Service charges on deposit accounts | \$ 314                 | \$ 303  |
| Mortgage lending income             | 482                    | 1,330   |
| Bank-owned life insurance           | 126                    | 98      |
| Securities gains (losses), net      | 1,050                  | (2,123) |
| Other                               | 324                    | 303     |
| Total noninterest income            | \$ 2,296               | \$ (89) |

The major components of noninterest income are service charges on deposit accounts, mortgage lending income, income from bank-owned life insurance, securities gains (losses), net, and other noninterest income. The following table presents a breakdown of the Company's mortgage lending income.

|                               | Quarter ended March 31 |          |
|-------------------------------|------------------------|----------|
|                               | 2010                   | 2009     |
| <i>(Dollars in thousands)</i> |                        |          |
| Origination income            | \$ 392                 | \$ 1,248 |
| Servicing fees, net           | 90                     | 82       |
| Total mortgage lending income | \$ 482                 | \$ 1,330 |

The Company's income from mortgage lending is primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing mortgage loans. The Company's normal practice is to originate mortgage loans for sale in the secondary market and to either release or retain the associated mortgage servicing rights (MSRs) when the loan is sold. Prior to January 1, 2009, the volume of loans sold servicing retained was not significant; therefore no servicing rights were capitalized. 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.

Mortgage lending income was \$0.5 million in the first quarter of 2010, compared to \$1.3 million in the first quarter of 2009. A significant decrease in the level of mortgage refinance activity during the first quarter of 2010 when compared to the record levels experienced in the first quarter of 2009 contributed to lower mortgage lending income during the first quarter of 2010.

The Company recorded net securities gains of \$1.1 million in the first quarter of 2010, compared to net securities losses of \$2.1 million in the first quarter of 2009. The change in net securities gains (losses) is primarily due to a significant decline in other-than-temporary impairment charges in the first quarter of 2010 when compared to the first quarter of 2009. Other-than-temporary impairment charges recognized in earnings were approximately \$0.1 million in the first quarter of 2010, compared to approximately \$3.0 million in the first quarter of 2009. Other-than-temporary impairment charges recognized in earnings for the first quarter of 2009 were primarily related to the Company's

investments in the common stock and trust preferred securities related to Silverton Financial Services, Inc.

**Table of Contents****Noninterest Expense**

|                                       | Quarter ended March 31 |          |
|---------------------------------------|------------------------|----------|
|                                       | 2010                   | 2009     |
| <i>(Dollars in thousands)</i>         |                        |          |
| Salaries and benefits                 | \$ 1,905               | \$ 2,049 |
| Net occupancy and equipment           | 384                    | 344      |
| Professional fees                     | 176                    | 161      |
| FDIC and other regulatory assessments | 276                    | 197      |
| Other                                 | 895                    | 802      |
| Total noninterest expense             | \$ 3,636               | \$ 3,553 |

The major components of noninterest expense are salaries and benefits, net occupancy and equipment, professional fees, FDIC and other regulatory assessments, and other noninterest expense.

Salaries and benefits expense was \$1.9 million in the first quarter of 2010, compared to \$2.0 million in the first quarter of 2009. The primary driver of the decrease related to decreases in commissions paid to our mortgage originators as a result of decreased origination volume.

FDIC and other regulatory assessments expense was \$0.3 million in 2010, compared to \$0.2 million in 2009. As a result of the requirement to increase the FDIC's Bank Insurance Fund to statutory levels over a prescribed period of time and increased pressure on the fund's reserves due to the increasing number of bank failures, FDIC insurance costs have increased for all insured depository institutions. The Company anticipates more bank failures through the duration of this credit cycle resulting in higher assessments for all institutions.

**Income Tax Expense**

Income tax expense was \$0.4 million in the first quarter of 2010, compared to \$0.1 million in the first quarter of 2009. This change was primarily due to an increase in the level of earnings before taxes in the first quarter of 2010 when compared to the first quarter of 2009. The annualized effective tax rate for the first quarter of 2010 was 20.77%, compared to an annualized effective income tax rate of 26.13% for the first quarter of 2009. The decrease in the Company's annualized effective tax rate in the first quarter of 2010 when compared to the first quarter of 2009 was primarily due to no change in the amount of deferred tax assets that management believes will more-likely-than-not be realized. The effective tax rate for the first quarter of 2009 reflected the impact of a change in the deferred tax asset valuation allowance related to nondeductible capital losses.

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

Securities available-for-sale were \$333.7 million and \$334.8 million as of March 31, 2010 and December 31, 2009, respectively. The net unrealized gain on securities available-for-sale was \$1.3 million at March 31, 2010 compared to a net unrealized gain of \$0.2 million at December 31, 2009. Increases in the fair value of securities available-for-sale during the first quarter of 2010 were primarily driven by changes in interest rates and the narrowing of credit spreads.

The average yields earned on total securities were 4.48% in the first quarter of 2010 and 5.13% in the first quarter of 2009.

**Table of Contents****Loans**

|                                        | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | 2009<br>Second<br>Quarter | First<br>Quarter |
|----------------------------------------|--------------------------|-------------------|--------------------------|---------------------------|------------------|
| <i>(In thousands)</i>                  |                          |                   |                          |                           |                  |
| Commercial, financial and agricultural | \$ 52,918                | \$ 53,884         | \$ 54,350                | \$ 52,397                 | \$ 52,463        |
| Construction and land development      | 57,945                   | 56,820            | 56,956                   | 53,304                    | 70,828           |
| Real estate - mortgage:                |                          |                   |                          |                           |                  |
| Commercial                             | 158,781                  | 156,928           | 156,356                  | 147,843                   | 137,253          |
| Residential                            | 99,660                   | 97,407            | 106,932                  | 108,576                   | 103,004          |
| Consumer installment                   | 11,475                   | 11,236            | 11,065                   | 11,330                    | 10,887           |
| Total loans                            | 380,779                  | 376,275           | 385,659                  | 373,450                   | 374,435          |
| Less: unearned income                  | (160)                    | (172)             | (211)                    | (229)                     | (250)            |
| Loans, net of unearned income          | \$ 380,619               | \$ 376,103        | \$ 385,448               | \$ 373,221                | \$ 374,185       |

Total loans, net of unearned income, were \$380.6 million as of March 31, 2010, an increase of \$4.5 million, or 1%, from \$376.1 million at December 31, 2009. Four loan categories represented the majority of the loan portfolio as of March 31, 2010. Commercial real estate mortgage loans represented 42%, residential real estate mortgage loans represented 26%, construction and land development loans represented 15% and commercial, financial and agricultural loans represented 14% of the Company's total loans at March 31, 2010. Owner-occupied commercial real estate mortgage loans were approximately 26% of the Company's total loan portfolio at March 31, 2010.

Within the residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately \$25.9 million, or 7%, of total loans, net of unearned income at both March 31, 2010 and December 31, 2009. For residential real estate mortgage loans with a consumer purpose, approximately \$5.5 million and \$5.8 million required interest only payments at March 31, 2010 and December 31, 2009, respectively. The Company's residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high risk consumer mortgage products.

Purchased loan participations included in the Company's loan portfolio were approximately \$8.3 million and \$9.4 million as of March 31, 2010 and December 31, 2009, respectively. All purchased loan participations are underwritten by the Company and independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company's normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures as described under **CRITICAL ACCOUNTING POLICIES**.

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

We attempt to reduce these economic and credit risks by adherence to loan to value guidelines for collateralized loans, by investigating the creditworthiness of the borrower and by monitoring the borrower's financial position. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit our exposure by prohibiting loan relationships that exceed 10% of the capital accounts of the bank if such loans are not secured or 20% of the capital accounts if loans in excess of 10% are fully secured, which would approximate \$13.1 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$11.8 million. Our loan policy requires that the Loan Committee of the Bank's Board of Directors approve any loan relationships that exceed this internal limit. At March 31, 2010 and December 31, 2009, the Company had no loan relationships exceeding these limits.

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

| <i>(In thousands)</i>                           | <b>March 31,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|-------------------------------------------------|---------------------------|------------------------------|
| Lessors of 1 to 4 family residential properties | \$ 36,837                 | \$ 34,961                    |
| Office buildings:                               |                           |                              |
| Owner occupied                                  | 16,288                    | 15,740                       |
| Non-owner occupied                              | 5,012                     | 5,382                        |
| Total office buildings                          | 21,300                    | 21,122                       |
| Hotel/Motel (all owner-occupied)                | \$ 16,911                 | \$ 17,114                    |

The average yield earned on loans and loans held for sale was 5.77% in the first quarter of 2010 and 5.74% in the first quarter of 2009.

**Allowance for Loan Losses**

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

A summary of the changes in the allowance for loan losses and certain asset quality ratios for the first quarter of 2010 and the previous four quarters is presented below.

| <i>(Dollars in thousands)</i>          | <b>2010<br/>First<br/>Quarter</b> | <b>Fourth<br/>Quarter</b> | <b>2009<br/>Third<br/>Quarter</b> | <b>Second<br/>Quarter</b> | <b>First<br/>Quarter</b> |
|----------------------------------------|-----------------------------------|---------------------------|-----------------------------------|---------------------------|--------------------------|
| Balance at beginning of period         | \$ 6,495                          | 5,458                     | 4,646                             | 4,532                     | 4,398                    |
| Charge-offs:                           |                                   |                           |                                   |                           |                          |
| Commercial, financial and agricultural | (68)                              | (91)                      | (128)                             |                           | (276)                    |
| Construction & land development        | (1,293)                           | (1,629)                   |                                   | (459)                     |                          |
| Residential real estate - mortgage     | (46)                              | (202)                     | (204)                             | (144)                     | (154)                    |
| Consumer installment                   | (5)                               | (17)                      | (10)                              | (23)                      | (11)                     |
| Total charge-offs                      | (1,412)                           | (1,939)                   | (342)                             | (626)                     | (441)                    |
| Recoveries                             | 13                                | 76                        | 54                                | 40                        | 25                       |
| Net charge-offs                        | (1,399)                           | (1,863)                   | (288)                             | (586)                     | (416)                    |
| Provision for loan losses              | 1,450                             | 2,900                     | 1,100                             | 700                       | 550                      |
| Ending balance                         | \$ 6,546                          | 6,495                     | 5,458                             | 4,646                     | 4,532                    |

|                                         |       |      |      |      |      |
|-----------------------------------------|-------|------|------|------|------|
| as a % of loans                         | 1.72% | 1.73 | 1.42 | 1.24 | 1.21 |
| as a % of nonperforming loans           | 60%   | 69   | 64   | 720  | 100  |
| Net charge-offs as a % of average loans | 1.48% | 1.95 | 0.31 | 0.63 | 0.45 |

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 quality indications and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.72% at March 31, 2010, compared to 1.73% at December 31, 2009. In the future, the allowance to total loans outstanding ratio will increase or decrease to the





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extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken.

Net charge-offs during the quarter ended March 31, 2010 primarily related to one construction and land development loan. The charge-off related to this loan, which was recognized during the quarter ended March 31, 2010, was equal to its corresponding valuation allowance (included in the allowance for loan losses) of \$1.3 million at December 31, 2009.

At March 31, 2010, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 60%, compared to 69% at December 31, 2009. The decrease in this ratio was primarily due to an increase in nonperforming loans that (1) the Company believes are well-collateralized based on current appraisals and other comparable sales data or (2) have already been impaired and written down to fair value less costs to sell.

At March 31, 2010, the Company's recorded investment in loans considered impaired was \$10.7 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$1.1 million. At December 31, 2009, the Company's recorded investment in loans considered impaired was \$9.7 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$1.3 million.

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

**Nonperforming Assets**

At March 31, 2010 the Company had \$18.0 million in nonperforming assets compared to \$16.6 million at December 31, 2009. Included in nonperforming assets were nonperforming loans of \$10.9 million and \$9.4 million at March 31, 2010 and December 31, 2009, respectively. Although the majority of the balance in nonperforming assets at March 31, 2010 related to deterioration in the construction and land development loan portfolio, the increase in nonperforming assets from December 31, 2009 was primarily driven by loans secured by residential real estate due to the impact of continuing economic distress, including the high rate of unemployment.

The table below provides information concerning total nonperforming assets and certain asset quality ratios for the first quarter of 2010 and the previous four quarters.

|                                                                | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
|----------------------------------------------------------------|--------------------------|-------------------|--------------------------|-------------------|------------------|
| <i>(In thousands)</i>                                          |                          |                   |                          |                   |                  |
| <b>Nonperforming assets:</b>                                   |                          |                   |                          |                   |                  |
| Nonaccrual loans                                               | \$ 10,934                | 9,352             | 8,490                    | 645               | 4,537            |
| Other nonperforming assets (primarily other real estate owned) | 7,081                    | 7,292             | 5,279                    | 5,149             | 113              |
| Total nonperforming assets                                     | \$ 18,015                | 16,644            | 13,769                   | 5,794             | 4,650            |
| as a % of loans and foreclosed properties                      | 4.65%                    | 4.34              | 3.52                     | 1.53              | 1.24             |
| as a % of total assets                                         | 2.28%                    | 2.15              | 1.75                     | 0.72              | 0.58             |
| Nonaccrual loans as a % of loans                               | 2.87%                    | 2.49              | 2.20                     | 0.17              | 1.21             |
| Accruing loans 90 days or more past due                        | \$ 374                   | 5                 | 122                      | 28                | 56               |

The Lee County Association of Realtors (LCAR) of Alabama reported that the average median selling price for residential homes during the quarter ended March 31, 2010 was \$172,549, an increase of 4.0% from the same quarter a year earlier. LCAR also reported that residential inventory at March 31, 2009 was 1,417 homes, an increase of 10.0% from a year earlier and the average number of days on the market for residential homes sold during the quarter ended March 31, 2010 was 159 days. Although stable median home prices are positive signs for this market, the supply of housing and the average number of days on the market for homes sold remain elevated. Continued weakness in the real estate market and the overall economy could adversely affect the Company's volume of nonperforming assets. For additional discussion of risk factors, see Part I Item 1A. Risk Factors on page 17 in our annual report on Form 10-K for the year ended December 31, 2009.

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The table below provides information concerning the composition of nonaccrual loans for the first quarter of 2010 and the previous four quarters.

|                                              | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
|----------------------------------------------|--------------------------|-------------------|--------------------------|-------------------|------------------|
| <i>(In thousands)</i>                        |                          |                   |                          |                   |                  |
| <b>Nonaccrual loans:</b>                     |                          |                   |                          |                   |                  |
| Construction and land development            | \$ 6,500                 | \$ 7,542          | \$ 6,652                 | \$ 97             | \$ 4,426         |
| Real estate - mortgage:                      |                          |                   |                          |                   |                  |
| Commercial                                   | 1,730                    | 961               | 856                      |                   |                  |
| Residential                                  | 2,687                    | 842               | 972                      | 538               | 100              |
| Consumer installment                         | 17                       | 7                 | 10                       | 10                | 11               |
| Total nonaccrual loans / nonperforming loans | \$ 10,934                | \$ 9,352          | \$ 8,490                 | \$ 645            | \$ 4,537         |

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At March 31, 2010, the Company had \$10.9 million in loans on nonaccrual, compared to \$9.4 million at December 31, 2009. Approximately \$5.6 million of total nonaccrual loans at March 31, 2010 related to two construction and land development loans. One loan is secured by a completed residential condominium project located in the Company's primary markets. The other loan is a purchased participation secured by partially developed land located near the Florida Gulf Coast.

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

The Company had \$374 thousand and \$5 thousand in loans 90 days past due and still accruing interest at March 31, 2010 and December 31, 2009, respectively.

The table below provides information concerning the composition of other real estate owned for the first quarter of 2010 and the previous four quarters.

|                                 | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
|---------------------------------|--------------------------|-------------------|--------------------------|-------------------|------------------|
| <i>(In thousands)</i>           |                          |                   |                          |                   |                  |
| <b>Other real estate owned:</b> |                          |                   |                          |                   |                  |
| Residential condo development   | \$ 4,329                 | \$ 4,329          | \$ 4,329                 | \$ 4,329          | \$               |
| New home construction           | 253                      | 490               | 650                      | 574               |                  |
| Developed lots                  | 136                      | 136               | 169                      | 96                |                  |
| Undeveloped land                | 2,210                    | 2,210             |                          |                   |                  |
| Other                           | 153                      | 127               | 131                      | 150               | 113              |
| Total other real estate owned   | \$ 7,081                 | \$ 7,292          | \$ 5,279                 | \$ 5,149          | \$ 113           |

The Company owned \$7.1 million in other real estate, which we had acquired from borrowers at March 31, 2010, compared to \$7.3 million at December 31, 2009. At March 31, 2010, other real estate owned included two properties with a total carrying value of \$6.5 million. The first property is undeveloped land located near the Company's primary markets. The second property is a completed condominium project on the Florida Gulf Coast. The Company had previously purchased a participation interest in the first lien mortgage loan on this property from Silverton Bank. Subsequently, this loan defaulted and was foreclosed upon and the Company's interest in the property is currently included in other real estate owned. Following Silverton Bank's failure on May 1, 2009, the FDIC has held this property as the receiver of Silverton Bank. CB Richard Ellis, a national real estate firm, has been managing this property and selling condominiums in the project as a FDIC contractor. The Company depends upon the FDIC and CB Richard Ellis for information regarding this property and its performance. Based upon the latest information available to us, including appraisals, current unit sales,



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and comparable sales, we believe that the fair value of the Company's interest in these properties, less selling costs, exceeds the Company's recorded investment.

**Potential Problem Loans**

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. Potential problem loans, which are not included in nonperforming assets, amounted to \$14.5 million, or 3.8% of total loans outstanding, net of unearned income at March 31, 2010, compared to \$16.8 million, or 4.5% of total loans outstanding, net of unearned income at December 31, 2009. The decrease in potential problem loans primarily related to certain residential real estate mortgage loans being placed on nonaccrual status. Continued weakness in the real estate market and the overall economy has adversely affected the Company's volume of potential problem loans, and these economic conditions are expected to persist for the foreseeable future.

The table below provides information concerning the composition of potential problem loans for the first quarter of 2010 and the previous four quarters.

|                                         | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
|-----------------------------------------|--------------------------|-------------------|--------------------------|-------------------|------------------|
| <i>(In thousands)</i>                   |                          |                   |                          |                   |                  |
| <b>Potential problem loans:</b>         |                          |                   |                          |                   |                  |
| Commercial, financial, and agricultural | \$ 1,430                 | \$ 1,771          | \$ 1,560                 | \$ 718            | \$ 757           |
| Construction and land development       | 1,636                    | 1,682             | 6,070                    | 3,196             | 1,363            |
| Real estate - mortgage:                 |                          |                   |                          |                   |                  |
| Commercial                              | 5,313                    | 5,659             | 1,504                    |                   |                  |
| Residential                             | 5,981                    | 7,502             | 6,872                    | 7,964             | 3,080            |
| Consumer installment                    | 149                      | 198               | 217                      | 59                | 61               |
| Total potential problem loans           | \$ 14,509                | \$ 16,812         | \$ 16,223                | \$ 11,937         | \$ 5,261         |

At March 31, 2010, approximately \$2.9 million or 19.8% of total potential problem loans were past due at least 30 days but less than 90 days.

The following table is a summary of the Company's performing loans that were past due at least 30 days but less than 90 days for the first quarter of 2010 and the previous four quarters.

|                                                 | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
|-------------------------------------------------|--------------------------|-------------------|--------------------------|-------------------|------------------|
| <i>(In thousands)</i>                           |                          |                   |                          |                   |                  |
| <b>Performing loans past due 30 to 90 days:</b> |                          |                   |                          |                   |                  |
| Commercial, financial, and agricultural         | \$ 206                   | \$ 339            | \$ 398                   | \$ 280            | \$ 255           |
| Construction and land development               | 20                       | 137               | 518                      | 47                | 37               |
| Real estate - mortgage:                         |                          |                   |                          |                   |                  |
| Commercial                                      | 1,658                    | 1,048             | 890                      |                   |                  |
| Residential                                     | 3,357                    | 1,626             | 736                      | 161               | 2,603            |
| Consumer installment                            | 3                        | 46                | 82                       | 72                | 47               |
| Total performing loans past due 30 to 90 days   | \$ 5,244                 | \$ 3,196          | \$ 2,624                 | \$ 560            | \$ 2,942         |

**Deposits**

Total deposits were \$608.6 million and \$579.4 million at March 31, 2010, and December 31, 2009, respectively. The increase of \$29.2 million in total deposits from December 31, 2009 was largely due to increases in noninterest bearing demand deposits, interest bearing demand deposits (or NOW accounts), and money market accounts. The increase of \$6.0 million in noninterest bearing deposits is primarily due to an increase in the number of new accounts and an increase in the balances of existing customer accounts. The increase of \$14.1 million in NOW accounts primarily relates to seasonal increases in public depositor account balances. The increase of \$6.5 million in money market accounts reflects

decreases in interest rates and related shifts as customers sought more yield in a low interest rate environment.

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The average rates paid on total interest-bearing deposits were 2.08% in the first quarter of 2010 and 2.82% in the first quarter of 2009.

Noninterest bearing deposits were 14% and 13% of total deposits as of March 31, 2010 and December 31, 2009, respectively.

### **Other Borrowings**

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased, securities sold under agreements to repurchase, and other short-term borrowings. The Bank had available federal funds lines totaling \$34.0 million with none outstanding at March 31, 2010, compared to \$34.0 million with \$12.5 million outstanding at December 31, 2009. Securities sold under agreements to repurchase totaled \$2.4 million at March 31, 2010, compared to \$3.5 million at December 31, 2009.

The average rate paid on short-term borrowings was 0.71% in the first quarter of 2010 and 0.51% in the first quarter of 2009.

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

The average rate paid on long-term debt was 4.03% in the first quarter of 2010 and 3.98% in the first quarter of 2009.

### **CAPITAL ADEQUACY**

The Company's consolidated stockholders' equity balances were \$57.8 million and \$56.2 million as of March 31, 2010 and December 31, 2009, respectively. The increase from December 31, 2009 is primarily driven by net earnings of \$1.6 million and other comprehensive income due to the change in unrealized gains (losses) on securities available-for-sale of \$0.7 million, which was offset by cash dividends paid of approximately \$0.7 million.

The Company's tier 1 leverage ratio was 8.17%, tier 1 risk-based capital ratio was 13.76% and total risk-based capital ratio was 15.01% at March 31, 2010. 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.

### **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 believes that interest rate risk is best estimated by our earnings simulation modeling. 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 percent 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 would indicate that we are in compliance with our current guidelines at March 31, 2010.

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





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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 30 percent. The results of our current economic value of equity model would indicate that we are in compliance with our current guidelines at March 31, 2010.

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. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. 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 March 31, 2010 and December 31, 2009, the Company had no derivative contracts to assist in managing interest rate sensitivity.

## **Liquidity Risk Management**

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

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

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

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, 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 March 31, 2010, the Bank had an available line of credit with the FHLB totaling \$236.2 million with \$86.1 million outstanding. At March 31, 2010, the Bank also had \$34.0 million of federal funds lines with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

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

## **Off-Balance Sheet Arrangements**

At March 31, 2010, the Bank had outstanding standby letters of credit of \$8.0 million and unfunded loan commitments outstanding of \$51.1 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



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fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or draw on its available credit facilities.

The Company also has commitments to fund certain affordable housing investments. The Company invests in various limited partnerships that sponsor affordable housing projects in its primary markets and surrounding areas as a means of supporting local communities. These investments are designed to generate a return primarily through the realization of federal tax credits. The Company typically provides financing during the construction and development of the properties; however, permanent financing is generally obtained from independent parties upon completion of a project. As of March 31, 2010 had investments of \$1.8 million, related to these projects, which are included in other assets on the Consolidated Balance Sheets. The Company's outstanding commitments to fund affordable housing investments totaled \$5.1 million at March 31, 2010. When commitments to fund affordable housing investments are contingent upon a future event, a liability must be recognized when that contingent event becomes probable. As of March 31, 2010, the Company had \$0.7 million in unfunded commitments related to affordable housing investments included in other liabilities. Additionally, the Company had outstanding loan commitments with certain of the partnerships totaling \$11.4 million at March 31, 2010. The funded portion of these loans was approximately \$0.8 million at March 31, 2010. The funded portions of these loans are included in loans, net of unearned income on the Consolidated Balance Sheets.

## **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.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

Effective July 1, 2009, the Financial Accounting Standards Board (FASB) established the Accounting Standards Codification (ASC or the Codification) as the source of authoritative generally accepted accounting principles (GAAP) for companies to use in the preparation of financial statements. SEC rules and interpretive releases are also authoritative GAAP for SEC registrants. The guidance contained in the Codification supersedes all existing non-SEC accounting and reporting standards. The Company adopted the Codification, as required, in the third quarter of 2009. As a result, references to accounting literature contained in our financial statement disclosures have been updated to reflect the new Codification structure.

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

Accounting Standards Update (ASU) 2009-16, *Accounting for Transfers of Financial Assets* (SFAS No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*); and

ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*); and

ASU 2010-6, *Improving Disclosures about Fair Value Measurements*.

ASU 2010-10, *Consolidation: Amendments for Certain Investment Funds*

In addition, the following accounting pronouncements were issued by the FASB, but are not yet effective:

ASU 2010-11, *Derivatives and Hedging: Scope Exception Related to Embedded Credit Derivatives*  
Information about these pronouncements is described in more detail below.

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ASU 2009-16, *Accounting for Transfers of Financial Assets* (SFAS No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*), modifies certain guidance contained in FASB ASC 860, *Transfers and Servicing*. This standard eliminates the concept of qualifying special purpose entities (QSPEs) and provides additional criteria transferors must use to evaluate transfers of financial assets. To determine if a transfer is to be accounted for as a sale, the transferor must assess whether it and all of the entities included in its consolidated financial statements have surrendered control of the assets. A transferor must consider all arrangements or agreements made or contemplated at the

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time of transfer before reaching a conclusion on whether control has been relinquished. SFAS No. 166 addresses situations in which a portion of a financial asset is transferred. In such instances the transfer can only be accounted for as a sale when the transferred portion is considered to be a participating interest. SFAS No. 166 also requires that any assets or liabilities retained from a transfer accounted for as a sale be initially recognized at fair value. This standard is effective for the Company as of January 1, 2010, with adoption applied prospectively for transfers that occur on and after the effective date. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company.

ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*), amends several key consolidation provisions related to variable interest entities ( VIEs ), which are included in FASB ASC 810, *Consolidation*. First, the scope of FAS 167 includes entities that are currently designated as QSPEs. Second, FAS 167 changes the approach companies use to identify the VIEs for which they are deemed to be the primary beneficiary and are required to consolidate. Under existing rules, the primary beneficiary is the entity that absorbs the majority of a VIE's losses and receives the majority of the VIE's returns. The guidance in FAS 167 identifies a VIE's primary beneficiary as the entity that has the power to direct the VIE's significant activities, and has an obligation to absorb losses or the right to receive benefits that could be potentially significant to the VIE. Third, FAS 167 requires companies to continually reassess whether they are the primary beneficiary of a VIE. Existing rules only require companies to reconsider primary beneficiary conclusions when certain triggering events have occurred. SFAS No. 167 is effective for the Company as of January 1, 2010, and applies to all current QSPEs and VIEs, and VIEs created after the effective date. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company.

ASU 2010-6, *Improving Disclosures about Fair Value Measurements*, changes the disclosure requirements for fair value measurements. The Update requires expanded disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (ii) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. The Update further clarifies that (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) company's should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy will be required for the Corporation beginning January 1, 2011. The remaining disclosure requirements and clarifications in the Update became effective for the Company on January 1, 2010. Adoption did not affect the Company's consolidated financial results since it amended only the disclosure requirements for fair value measurements. See Note 7 of the Condensed Consolidated Financial Statements.

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

ASU 2010-11, *Derivatives and Hedging: Scope Exception Related to Embedded Credit Derivatives*, which amends and clarifies the accounting for credit derivatives embedded in interests in securitized financial assets. ASU 2010-11 is effective for interim periods beginning after June 15, 2010. The adoption of ASU 2010-11 is not expected to have a material impact to the 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 reconciliation of these non-GAAP financial measures from GAAP to non-GAAP are presented below.

|                                             | 2010             |                   | 2009             |                   |                  |
|---------------------------------------------|------------------|-------------------|------------------|-------------------|------------------|
|                                             | First<br>Quarter | Fourth<br>Quarter | Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
| <i>(in thousands)</i>                       |                  |                   |                  |                   |                  |
| <b>Net interest income (GAAP)</b>           | <b>\$ 4,831</b>  | <b>5,109</b>      | <b>4,662</b>     | <b>4,519</b>      | <b>4,525</b>     |
| Tax-equivalent adjustment                   | 437              | 438               | 432              | 404               | 359              |
| <b>Net interest income (Tax-equivalent)</b> | <b>\$ 5,268</b>  | <b>5,547</b>      | <b>5,094</b>     | <b>4,923</b>      | <b>4,884</b>     |

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

|                                                         | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
|---------------------------------------------------------|--------------------------|-------------------|--------------------------|-------------------|------------------|
| <i>(Dollars in thousands, except per share amounts)</i> |                          |                   |                          |                   |                  |
| <b>Results of Operations</b>                            |                          |                   |                          |                   |                  |
| Net interest income (a)                                 | \$ 5,268                 | 5,547             | 5,094                    | 4,923             | 4,884            |
| Less: tax-equivalent adjustment                         | 437                      | 438               | 432                      | 404               | 359              |
| Net interest income (GAAP)                              | 4,831                    | 5,109             | 4,662                    | 4,519             | 4,525            |
| Noninterest income (loss)                               | 2,296                    | 799               | 1,159                    | 1,263             | (89)             |
| Total revenue                                           | 7,127                    | 5,908             | 5,821                    | 5,782             | 4,436            |
| Provision for loan losses                               | 1,450                    | 2,900             | 1,100                    | 700               | 550              |
| Noninterest expense                                     | 3,636                    | 3,735             | 3,421                    | 3,924             | 3,553            |
| Income tax expense                                      | 424                      | (930)             | 277                      | 226               | 87               |
| Net earnings                                            | \$ 1,617                 | 203               | 1,023                    | 932               | 246              |
| <b>Per share data:</b>                                  |                          |                   |                          |                   |                  |
| Basic and diluted net earnings                          | \$ 0.44                  | 0.06              | 0.28                     | 0.25              | 0.07             |
| Cash dividends declared                                 | 0.195                    | 0.190             | 0.190                    | 0.190             | 0.190            |
| Weighted average shares outstanding:                    |                          |                   |                          |                   |                  |
| Basic and diluted                                       | 3,643,116                | 3,643,395         | 3,644,097                | 3,644,491         | 3,646,827        |
| Shares outstanding, at period end                       | 3,643,112                | 3,643,117         | 3,644,097                | 3,644,097         | 3,644,957        |
| Book value                                              | \$ 15.86                 | 15.42             | 16.03                    | 14.53             | 15.14            |
| Common stock price                                      |                          |                   |                          |                   |                  |
| High                                                    | \$ 21.95                 | 25.98             | 29.99                    | 30.00             | 26.40            |
| Low                                                     | 17.61                    | 18.93             | 22.50                    | 21.75             | 18.07            |
| Period end:                                             | 20.65                    | 19.69             | 24.40                    | 28.50             | 21.00            |
| To earnings ratio                                       | 19.86x                   | 29.39             | 28.05                    | 25.22             | 15.22            |
| To book value                                           | 130%                     | 128               | 152                      | 196               | 139              |
| <b>Performance ratios:</b>                              |                          |                   |                          |                   |                  |
| Return on average equity                                | 11.31%                   | 1.37              | 7.64                     | 6.63              | 1.70             |
| Return on average assets                                | 0.82%                    | 0.10              | 0.52                     | 0.46              | 0.13             |
| Dividend payout ratio                                   | 44.32%                   | 316.67            | 67.86                    | 73.08             | 271.43           |
| <b>Asset Quality:</b>                                   |                          |                   |                          |                   |                  |
| Allowance for loan losses as a % of:                    |                          |                   |                          |                   |                  |
| Loans                                                   | 1.72%                    | 1.73              | 1.42                     | 1.24              | 1.21             |
| Nonperforming loans                                     | 60%                      | 69                | 64                       | 720               | 100              |
| Nonperforming assets as a % of:                         |                          |                   |                          |                   |                  |
| Loans and foreclosed properties                         | 4.65%                    | 4.34              | 3.52                     | 1.53              | 1.24             |
| Total assets                                            | 2.28%                    | 2.15              | 1.75                     | 0.72              | 0.58             |
| Nonperforming loans as a % of total loans               | 2.87%                    | 2.49              | 2.20                     | 0.17              | 1.21             |
| Net charge-offs as a % of average loans                 | 1.48%                    | 1.95              | 0.31                     | 0.63              | 0.45             |
| <b>Capital Adequacy:</b>                                |                          |                   |                          |                   |                  |
| Tier 1 risk-based capital ratio                         | 13.76%                   | 13.73             | 13.70                    | 13.81             | 13.77            |
| Total risk-based capital ratio                          | 15.01%                   | 14.98             | 14.88                    | 14.82             | 14.75            |
| Tier 1 Leverage Ratio                                   | 8.17%                    | 8.13              | 8.05                     | 7.89              | 8.10             |
| <b>Other financial data:</b>                            |                          |                   |                          |                   |                  |
| Net interest margin (a)                                 | 2.94%                    | 3.02              | 2.74                     | 2.64              | 2.72             |
| Effective income tax rate                               | 20.77%                   | NM                | 21.31                    | 19.52             | 26.13            |
| Efficiency ratio (b)                                    | 48.07%                   | 58.86             | 54.71                    | 63.43             | 74.10            |
| <b>Selected average balances:</b>                       |                          |                   |                          |                   |                  |
| Securities                                              | \$ 331,098               | 338,261           | 346,353                  | 353,168           | 338,435          |
| Loans, net of unearned income                           | 379,092                  | 381,112           | 377,170                  | 374,465           | 372,702          |
| Total assets                                            | 784,183                  | 777,363           | 790,885                  | 803,903           | 779,295          |
| Total deposits                                          | 599,021                  | 589,452           | 604,005                  | 611,224           | 580,921          |
| Long-term debt                                          | 118,347                  | 118,351           | 118,355                  | 120,997           | 123,365          |

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|                                      |            |         |         |         |         |
|--------------------------------------|------------|---------|---------|---------|---------|
| Total stockholders' equity           | 57,208     | 59,349  | 53,584  | 56,265  | 58,051  |
| <b>Selected period end balances:</b> |            |         |         |         |         |
| Securities                           | \$ 333,660 | 334,762 | 338,924 | 349,472 | 358,425 |
| Loans, net of unearned income        | 380,619    | 376,103 | 385,448 | 373,221 | 374,185 |
| Allowance for loan losses            | 6,546      | 6,495   | 5,458   | 4,646   | 4,532   |
| Total assets                         | 791,324    | 773,382 | 786,042 | 800,910 | 802,450 |
| Total deposits                       | 608,588    | 579,409 | 597,591 | 616,442 | 609,206 |
| Long-term debt                       | 118,345    | 118,349 | 118,355 | 118,358 | 123,363 |
| Total stockholders' equity           | 57,778     | 56,183  | 58,405  | 52,948  | 55,180  |

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

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

NM - not meaningful



**Table of Contents****Table 3 - Average Balances and Net Interest Income Analysis**

|                                                                       | Quarter ended March 31 |                                        |                |                    |                                        |                |
|-----------------------------------------------------------------------|------------------------|----------------------------------------|----------------|--------------------|----------------------------------------|----------------|
|                                                                       | Average<br>Balance     | 2010<br>Interest<br>Income/<br>Expense | Yield/<br>Rate | Average<br>Balance | 2009<br>Interest<br>Income/<br>Expense | Yield/<br>Rate |
| <i>(Dollars in thousands)</i>                                         |                        |                                        |                |                    |                                        |                |
| <b>Interest-earning assets:</b>                                       |                        |                                        |                |                    |                                        |                |
| Loans and loans held for sale (1)                                     | \$ 381,784             | \$ 5,433                               | 5.77%          | \$ 377,560         | \$ 5,346                               | 5.74%          |
| Securities - taxable                                                  | 250,286                | 2,367                                  | 3.84%          | 272,370            | 3,227                                  | 4.80%          |
| Securities - tax-exempt (2)                                           | 80,812                 | 1,289                                  | 6.47%          | 66,065             | 1,056                                  | 6.48%          |
| Total securities                                                      | 331,098                | 3,656                                  | 4.48%          | 338,435            | 4,283                                  | 5.13%          |
| Federal funds sold                                                    | 12,832                 | 7                                      | 0.22%          | 11,256             | 6                                      | 0.22%          |
| Interest bearing bank deposits                                        | 1,076                  |                                        | 0.00%          | 918                |                                        | 0.00%          |
| Total interest-earning assets                                         | 726,790                | \$ 9,096                               | 5.08%          | 728,169            | \$ 9,635                               | 5.37%          |
| Cash and due from banks                                               | 13,029                 |                                        |                | 16,895             |                                        |                |
| Other assets                                                          | 44,364                 |                                        |                | 34,231             |                                        |                |
| Total assets                                                          | \$ 784,183             |                                        |                | \$ 779,295         |                                        |                |
| <b>Interest-bearing liabilities:</b>                                  |                        |                                        |                |                    |                                        |                |
| Deposits:                                                             |                        |                                        |                |                    |                                        |                |
| NOW                                                                   | \$ 93,348              | \$ 176                                 | 0.76%          | \$ 86,417          | \$ 209                                 | 0.98%          |
| Savings and money market                                              | 104,334                | 288                                    | 1.12%          | 88,960             | 272                                    | 1.24%          |
| Certificates of deposits less than \$100,000                          | 150,912                | 901                                    | 2.42%          | 143,143            | 1,139                                  | 3.23%          |
| Certificates of deposits and other time deposits of \$100,000 or more | 166,961                | 1,275                                  | 3.10%          | 188,047            | 1,904                                  | 4.11%          |
| Total interest-bearing deposits                                       | 515,555                | 2,640                                  | 2.08%          | 506,567            | 3,524                                  | 2.82%          |
| Short-term borrowings                                                 | 6,256                  | 11                                     | 0.71%          | 12,799             | 16                                     | 0.51%          |
| Long-term debt                                                        | 118,347                | 1,177                                  | 4.03%          | 123,365            | 1,211                                  | 3.98%          |
| Total interest-bearing liabilities                                    | 640,158                | \$ 3,828                               | 2.43%          | 642,731            | \$ 4,751                               | 3.00%          |
| Noninterest-bearing deposits                                          | 83,466                 |                                        |                | 74,354             |                                        |                |
| Other liabilities                                                     | 3,351                  |                                        |                | 4,159              |                                        |                |
| Stockholders' equity                                                  | 57,208                 |                                        |                | 58,051             |                                        |                |
| Total liabilities and stockholders' equity                            | \$ 784,183             |                                        |                | \$ 779,295         |                                        |                |
| Net interest income and margin                                        |                        | \$ 5,268                               | 2.94%          |                    | \$ 4,884                               | 2.72%          |

(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 4 - Loan Portfolio Composition**

|                                        | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
|----------------------------------------|--------------------------|-------------------|--------------------------|-------------------|------------------|
| <i>(In thousands)</i>                  |                          |                   |                          |                   |                  |
| Commercial, financial and agricultural | \$ 52,918                | 53,884            | 54,350                   | 52,397            | 52,463           |
| Construction & land development        | 57,945                   | 56,820            | 56,956                   | 53,304            | 70,828           |
| Real estate - mortgage:                |                          |                   |                          |                   |                  |
| Commercial                             | 158,781                  | 156,928           | 156,356                  | 147,843           | 137,253          |
| Residential                            | 99,660                   | 97,407            | 106,932                  | 108,576           | 103,004          |
| Consumer installment                   | 11,475                   | 11,236            | 11,065                   | 11,330            | 10,887           |
| Total loans                            | 380,779                  | 376,275           | 385,659                  | 373,450           | 374,435          |
| Less: unearned income                  | (160)                    | (172)             | (211)                    | (229)             | (250)            |
| Loans, net of unearned income          | 380,619                  | 376,103           | 385,448                  | 373,221           | 374,185          |
| Less: allowance for loan losses        | (6,546)                  | (6,495)           | (5,458)                  | (4,646)           | (4,532)          |
| Loans, net                             | \$ 374,073               | 369,608           | 379,990                  | 368,575           | 369,653          |

**Table of Contents****Table 5 - Allowance for Loan Losses and Nonperforming Assets**

|                                                                   | 2010<br>First<br>Quarter | Fourth<br>Quarter | 2009<br>Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
|-------------------------------------------------------------------|--------------------------|-------------------|--------------------------|-------------------|------------------|
| <i>(Dollars in thousands)</i>                                     |                          |                   |                          |                   |                  |
| <b>Allowance for loan losses:</b>                                 |                          |                   |                          |                   |                  |
| Balance at beginning of period                                    | \$ 6,495                 | 5,458             | 4,646                    | 4,532             | 4,398            |
| Charge-offs:                                                      |                          |                   |                          |                   |                  |
| Commercial, financial and agricultural                            | (68)                     | (91)              | (128)                    |                   | (276)            |
| Construction & land development                                   | (1,293)                  | (1,629)           |                          | (459)             |                  |
| Residential real estate - mortgage                                | (46)                     | (202)             | (204)                    | (144)             | (154)            |
| Consumer installment                                              | (5)                      | (17)              | (10)                     | (23)              | (11)             |
| Total charge-offs                                                 | (1,412)                  | (1,939)           | (342)                    | (626)             | (441)            |
| Recoveries                                                        | 13                       | 76                | 54                       | 40                | 25               |
| Net charge-offs                                                   | (1,399)                  | (1,863)           | (288)                    | (586)             | (416)            |
| Provision for loan losses                                         | 1,450                    | 2,900             | 1,100                    | 700               | 550              |
| Ending balance                                                    | \$ 6,546                 | 6,495             | 5,458                    | 4,646             | 4,532            |
| as a % of loans                                                   | 1.72%                    | 1.73              | 1.42                     | 1.24              | 1.21             |
| as a % of nonperforming loans                                     | 60%                      | 69                | 64                       | 720               | 100              |
| Net charge-offs as a % of average loans                           | 1.48%                    | 1.95              | 0.31                     | 0.63              | 0.45             |
| <b>Nonperforming assets:</b>                                      |                          |                   |                          |                   |                  |
| Nonaccrual loans                                                  | \$ 10,934                | 9,352             | 8,490                    | 645               | 4,537            |
| Other nonperforming assets<br>(primarily other real estate owned) | 7,081                    | 7,292             | 5,279                    | 5,149             | 113              |
| Total nonperforming assets                                        | \$ 18,015                | 16,644            | 13,769                   | 5,794             | 4,650            |
| as a % of loans and foreclosed properties                         | 4.65%                    | 4.34              | 3.52                     | 1.53              | 1.24             |
| as a % of total assets                                            | 2.28%                    | 2.15              | 1.75                     | 0.72              | 0.58             |
| Nonperforming loans as a % of total loans                         | 2.87%                    | 2.49              | 2.20                     | 0.17              | 1.21             |
| Accruing loans 90 days or more past due                           | \$ 374                   | 5                 | 122                      | 28                | 56               |

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**Table 6 - Allocation of Allowance for Loan Losses**

|                                        | 2010          |                |               |                | 2009          |        |          |        |          |        |
|----------------------------------------|---------------|----------------|---------------|----------------|---------------|--------|----------|--------|----------|--------|
|                                        | First Quarter | Fourth Quarter | Third Quarter | Second Quarter | First Quarter | Amount | %*       | Amount | %*       | Amount |
| (Dollars in thousands)                 | Amount        | %*             | Amount        | %*             | Amount        | %*     | Amount   | %*     | Amount   | %*     |
| Commercial, financial and agricultural | \$ 738        | 13.9           | \$ 784        | 14.3           | \$ 731        | 14.1   | \$ 526   | 14.0   | \$ 401   | 14.0   |
| Construction and land development      | 1,180         | 15.2           | 2,063         | 15.1           | 1,292         | 14.8   | 816      | 14.3   | 918      | 18.9   |
| Real estate - mortgage:                |               |                |               |                |               |        |          |        |          |        |
| Commercial                             | 1,972         | 41.7           | 1,264         | 41.7           | 1,209         | 40.5   | 1,333    | 39.6   | 1,215    | 36.7   |
| Residential                            | 1,964         | 26.2           | 1,706         | 25.9           | 1,762         | 27.7   | 1,712    | 29.1   | 1,452    | 27.5   |
| Consumer installment                   | 207           | 3.0            | 227           | 3.0            | 202           | 2.9    | 140      | 3.0    | 143      | 2.9    |
| Unallocated                            | 485           |                | 451           |                | 262           |        | 119      |        | 403      |        |
| Total allowance for loan losses        | \$ 6,546      |                | \$ 6,495      |                | \$ 5,458      |        | \$ 4,646 |        | \$ 4,532 |        |

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

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**Table 7 - CDs and Other Time Deposits of \$100,000 or More**

| <i>(Dollars in thousands)</i>                              | <b>March 31, 2010</b> |
|------------------------------------------------------------|-----------------------|
| <b>Maturity of:</b>                                        |                       |
| 3 months or less                                           | \$ 14,156             |
| Over 3 months through 6 months                             | 37,398                |
| Over 6 months through 12 months                            | 56,937                |
| Over 12 months                                             | 94,842                |
| <br>Total CDs and other time deposits of \$100,000 or more | <br>\$ 203,333        |

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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.

**Table of Contents****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, 2009.

**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, 2009, 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 |           | Average Price Paid | Total Number of Shares |                                  | Maximum Number of      |
|--------------------------|-----------------|-----------|--------------------|------------------------|----------------------------------|------------------------|
|                          | Shares          | Purchased |                    | Purchased as Part of   | Plans or Programs <sup>(2)</sup> | Shares that May Yet Be |
|                          |                 |           | per Share          | Publicly Announced     |                                  | Purchased Under the    |
|                          |                 |           |                    |                        |                                  |                        |
| January 1 - January 31   |                 |           |                    |                        |                                  | 161,113                |
| February 1 - February 28 |                 | 25        | \$ 18.19           | 25                     |                                  | 161,088                |
| March 1 - March 31       |                 |           |                    |                        |                                  |                        |
| Total                    |                 | 25        | \$ 18.19           |                        |                                  |                        |

<sup>(1)</sup> Based on trade date, not settlement date.

<sup>(2)</sup> On April 8, 2008, the Company's Board of Directors authorized a stock repurchase program pursuant to which the Company was authorized to repurchase up to 200,000 shares of its common stock. The April 2008 authorization expired on February 28, 2010.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. REMOVED AND RESERVED****ITEM 5. OTHER INFORMATION**

Not applicable.





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### **ITEM 6. EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                                                                                                                                                                                                                              |
|---------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 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 E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.***                                                                  |
| 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 David A. Hedges, Vice President, Controller and Chief Financial Officer (Principal Financial and Accounting Officer).***                             |

\* 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.

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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: May 13, 2010

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

Date: May 13, 2010

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