

AUBURN NATIONAL BANCORPORATION INC

Form 10-Q

November 14, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**  
For the quarterly period ended September 30, 2007

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

Commission File Number: 0-26486

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**Auburn National Bancorporation, Inc.**

(Exact Name of Registrant as Specified in Its Charter)

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

**100 N. Gay Street**  
**Auburn, Alabama 36830**

**(334) 821-9200**

(Address and telephone number of principal executive offices)

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

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

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange 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 October 31, 2007 |
|---|---------------------------------|
| Common Stock, \$.01 par value per share | 3,691,215 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)**

| <i>(Dollars in thousands, except share data)</i>   | <b>September 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|--|-------------------------------|------------------------------|
| <b>Assets:</b>   |                               |                              |
| Cash and due from banks  | \$ 14,762                     | \$ 16,875                    |
| Federal funds sold   | 4,143                         |                              |
| Interest bearing bank deposits   | 422                           | 151                          |
| <b>Cash and cash equivalents</b>   | <b>19,327</b>                 | <b>17,026</b>                |
| Securities held-to-maturity (fair value of \$435 and \$514 for September 30, 2007 and December 31, 2006, respectively) | 434                           | 513                          |
| Securities available-for-sale  | 288,025                       | 301,424                      |
| Loans held for sale  | 4,503                         | 3,109                        |
| Loans  | 316,795                       | 281,983                      |
| Allowance for loan losses  | (4,074)                       | (4,044)                      |
| <b>Loans, net</b>  | <b>312,721</b>                | <b>277,939</b>               |
| Premises and equipment, net  | 2,346                         | 2,182                        |
| Rental property, net   | 4,132                         | 3,614                        |
| Bank-owned life insurance  | 14,694                        | 14,278                       |
| Other assets   | 15,598                        | 15,041                       |
| <b>Total assets</b>  | <b>\$ 661,780</b>             | <b>\$ 635,126</b>            |
| <b>Liabilities:</b>  |                               |                              |
| Deposits:  |                               |                              |
| Noninterest-bearing  | \$ 75,922                     | \$ 79,102                    |
| Interest-bearing   | 434,156                       | 390,546                      |
| <b>Total deposits</b>  | <b>510,078</b>                | <b>469,648</b>               |
| Federal funds purchased and securities sold under agreements to repurchase   | 7,637                         | 14,401                       |
| Other short-term borrowings  |                               | 10,000                       |
| Long-term debt   | 90,390                        | 90,404                       |
| Accrued expenses and other liabilities   | 3,172                         | 2,255                        |
| <b>Total liabilities</b>   | <b>611,277</b>                | <b>586,708</b>               |
| <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   | 3,748                         | 3,748                        |

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|   |            |            |
|---|------------|------------|
| Retained earnings   | 54,273     | 51,087     |
| Accumulated other comprehensive loss, net   | (2,049)    | (2,335)    |
| Less treasury stock, at cost - 265,875 shares and 213,348 shares for September 30, 2007 and December 31, 2006, respectively | (5,508)    | (4,121)    |
| Total stockholders' equity  | 50,503     | 48,418     |
| Total liabilities and stockholders' equity  | \$ 661,780 | \$ 635,126 |

*See accompanying notes to condensed consolidated financial statements*

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

|  | For the Three Months |                 | For the Nine Months |                 |
|--|----------------------|-----------------|---------------------|-----------------|
|  | Ended September 30   |                 | Ended September 30  |                 |
|  | 2007                 | 2006            | 2007                | 2006            |
| <i>(Dollars in thousands, except share and per share data)</i> |                      |                 |                     |                 |
| <b>Interest income:</b>  |                      |                 |                     |                 |
| Loans, including fees  | \$ 6,370             | \$ 5,845        | \$ 18,128           | \$ 16,728       |
| Securities   | 3,535                | 3,259           | 10,655              | 9,566           |
| Federal funds sold and interest bearing bank deposits          | 43                   | 89              | 187                 | 275             |
| <b>Total interest income</b>                                   | <b>9,948</b>         | <b>9,193</b>    | <b>28,970</b>       | <b>26,569</b>   |
| <b>Interest expense:</b>                                       |                      |                 |                     |                 |
| Deposits   | 4,402                | 3,833           | 12,746              | 10,735          |
| Short-term borrowings  | 160                  | 74              | 518                 | 229             |
| Long-term debt   | 1,062                | 1,160           | 3,129               | 3,452           |
| <b>Total interest expense</b>                                  | <b>5,624</b>         | <b>5,067</b>    | <b>16,393</b>       | <b>14,416</b>   |
| <b>Net interest income</b>                                     | <b>4,324</b>         | <b>4,126</b>    | <b>12,577</b>       | <b>12,153</b>   |
| <b>Provision for loan losses</b>                               |                      | 85              | 23                  | 295             |
| <b>Net interest income after provision for loan losses</b>     | <b>4,324</b>         | <b>4,041</b>    | <b>12,554</b>       | <b>11,858</b>   |
| <b>Noninterest income:</b>                                     |                      |                 |                     |                 |
| Service charges on deposit accounts                            | 325                  | 356             | 969                 | 1,048           |
| Servicing fees   | 82                   | 93              | 256                 | 284             |
| Gain on sale of loans held for sale                            | 157                  | 154             | 527                 | 474             |
| Bank-owned life insurance                                      | 135                  | 105             | 416                 | 341             |
| Securities gains (losses), net                                 | 5                    | (37)            | 29                  | 6               |
| Other  | 384                  | 419             | 1,217               | 1,205           |
| <b>Total noninterest income</b>                                | <b>1,088</b>         | <b>1,090</b>    | <b>3,414</b>        | <b>3,358</b>    |
| <b>Noninterest expense:</b>                                    |                      |                 |                     |                 |
| Salaries and benefits  | 1,813                | 1,720           | 5,371               | 5,078           |
| Net occupancy and equipment                                    | 328                  | 295             | 945                 | 881             |
| Professional fees  | 144                  | 109             | 497                 | 354             |
| Other  | 789                  | 725             | 2,294               | 2,116           |
| <b>Total noninterest expense</b>                               | <b>3,074</b>         | <b>2,849</b>    | <b>9,107</b>        | <b>8,429</b>    |
| <b>Earnings before income taxes</b>                            | <b>2,338</b>         | <b>2,282</b>    | <b>6,861</b>        | <b>6,787</b>    |
| <b>Income tax expense</b>                                      | <b>589</b>           | <b>621</b>      | <b>1,723</b>        | <b>1,749</b>    |
| <b>Net earnings</b>  | <b>\$ 1,749</b>      | <b>\$ 1,661</b> | <b>\$ 5,138</b>     | <b>\$ 5,038</b> |
| <b>Net earnings per share:</b>                                 |                      |                 |                     |                 |
| Basic and diluted  | \$ 0.47              | \$ 0.44         | \$ 1.38             | \$ 1.33         |

**Weighted average shares outstanding:**

|         |           |           |           |           |
|---------|-----------|-----------|-----------|-----------|
| Basic   | 3,708,097 | 3,775,649 | 3,725,744 | 3,781,918 |
| Diluted | 3,708,097 | 3,776,023 | 3,725,744 | 3,782,363 |

*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)**

| <i>(Dollars in thousands, except share and per share data)</i>   | Common Stock |        | Additional | Retained  | Accumulated   | Treasury   | Total     |
|--|--------------|--------|------------|-----------|---------------|------------|-----------|
|  | Shares       | Amount | paid-in    | earnings  | other         | stock      |           |
|  |              |        | capital    |           | comprehensive |            |           |
|  |              |        |            |           | loss          |            |           |
| <b>Balance, December 31, 2005</b>  | 3,957,135    | \$ 39  | \$ 3,734   | \$ 46,919 | \$ (3,982)    | \$ (2,756) | \$ 43,954 |
| Comprehensive income:  |              |        |            |           |               |            |           |
| Net earnings   |              |        |            | 5,038     |               |            | 5,038     |
| Other comprehensive income due to change in unrealized loss on securities available for sale and derivative, net |              |        |            |           | 408           |            | 408       |
| <b>Total comprehensive income</b>  |              |        |            | 5,038     | 408           |            | 5,446     |
| Cash dividends paid (\$0.48 per share)   |              |        |            | (1,815)   |               |            | (1,815)   |
| Stock repurchases (24,048 shares)  |              |        |            |           |               | (568)      | (568)     |
| Sale of treasury stock (600 shares)  |              |        | 4          |           |               | 4          | 8         |
| <b>Balance, September 30, 2006</b>   | 3,957,135    | \$ 39  | \$ 3,738   | \$ 50,142 | \$ (3,574)    | \$ (3,320) | \$ 47,025 |
| <b>Balance, December 31, 2006</b>  | 3,957,135    | \$ 39  | \$ 3,748   | \$ 51,087 | \$ (2,335)    | \$ (4,121) | \$ 48,418 |
| Comprehensive income:  |              |        |            |           |               |            |           |
| Net earnings   |              |        |            | 5,138     |               |            | 5,138     |
| Other comprehensive income due to change in unrealized loss on securities available for sale, net                |              |        |            |           | 286           |            | 286       |
| <b>Total comprehensive income</b>  |              |        |            | 5,138     | 286           |            | 5,424     |
| Cash dividends paid (\$0.525 per share)  |              |        |            | (1,952)   |               |            | (1,952)   |
| Stock repurchases (52,527 shares)  |              |        |            |           |               | (1,387)    | (1,387)   |
| <b>Balance, September 30, 2007</b>   | 3,957,135    | \$ 39  | \$ 3,748   | \$ 54,273 | \$ (2,049)    | \$ (5,508) | \$ 50,503 |

See accompanying notes to condensed consolidated financial statements

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

|   | Nine Months        |              |
|---|--------------------|--------------|
|   | Ended September 30 |              |
| <i>(In thousands)</i>   | 2007               | 2006         |
| <b>Cash flows from operating activities:</b>  |                    |              |
| Net earnings  | \$ 5,138           | \$ 5,038     |
| Adjustments to reconcile net income to net cash provided by operating activities:                     |                    |              |
| Provision for loan losses   | 23                 | 295          |
| Depreciation and amortization   | 294                | 296          |
| Premium amortization and discount accretion, net  | 73                 | 388          |
| Net loss (gain) on securities available for sale transactions   | 584                | (6)          |
| Net gain on sale of loans held for sale   | (527)              | (474)        |
| Gain on sale of privately-held stock investments  | (613)              |              |
| Gain on sale of other real estate owned   |                    | (3)          |
| Loans originated for sale   | (81,896)           | (60,000)     |
| Proceeds from sale of loans   | 81,029             | 58,000       |
| Increase in cash surrender value of bank owned life insurance   | (416)              | (341)        |
| Net increase in other assets  | (1,313)            | (2,612)      |
| Net increase in accrued expenses and other liabilities  | 917                | 253          |
| <br>Net cash provided by operating activities   | <br>3,293          | <br>834      |
| <b>Cash flows from investing activities:</b>  |                    |              |
| Proceeds from maturities of securities held-to-maturity   | 79                 | 90           |
| Proceeds from sales of securities available-for-sale  | 28,993             | 19,259       |
| Proceeds from maturities of securities available-for-sale   | 33,032             | 21,897       |
| Purchase of securities available-for-sale   | (48,806)           | (53,700)     |
| Net increase in loans   | (34,805)           | (2,063)      |
| Proceeds from sale of premises and equipment  |                    | 5            |
| Net purchases of premises and equipment   | (339)              | (89)         |
| Additions to rental property  | (605)              | (2,457)      |
| Proceeds from sale of other real estate   |                    | 279          |
| Proceeds from sale of privately-held stock investment   | 1,146              |              |
| <br>Net cash used in investing activities   | <br>(21,305)       | <br>(16,779) |
| <b>Cash flows from financing activities:</b>  |                    |              |
| Net (decrease) increase in noninterest-bearing deposits   | (3,180)            | 4,449        |
| Net increase in interest-bearing deposits   | 43,610             | 19,825       |
| Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase | (6,764)            | 5,256        |
| Net decrease in other short-term borrowings   | (10,000)           |              |
| Repayments or retirement of long-term debt  | (14)               | (5,013)      |
| Stock repurchases   | (1,387)            | (568)        |
| Proceeds from sale of treasury stock  |                    | 8            |
| Dividends paid  | (1,952)            | (1,815)      |
| <br>Net cash provided by financing activities   | <br>20,313         | <br>22,142   |

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|   |                  |                  |
|---|------------------|------------------|
| Net change in cash and cash equivalents           | 2,301            | 6,197            |
| Cash and cash equivalents at beginning of period  | 17,026           | 26,082           |
| <b>Cash and cash equivalents at end of period</b> | <b>\$ 19,327</b> | <b>\$ 32,279</b> |

**Supplemental disclosures of cash flow information:**

Cash paid during the period for:

|              |           |           |
|--------------|-----------|-----------|
| Interest     | \$ 16,006 | \$ 14,036 |
| Income taxes | 1,495     | 3,768     |

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

|  |  |     |
|--|--|-----|
| Real estate acquired through foreclosure |  | 276 |
|--|--|-----|

*See accompanying notes to condensed consolidated financial statements*

**Table of Contents****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Notes to the Condensed Consolidated Financial Statements****NOTE 1: BASIS OF PRESENTATION****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.

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 financial position and results of operations as of and for the nine months ended September 30, 2007 are not necessarily indicative of the results of operations that Auburn National Bancorporation, Inc. 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, 2006 and subsequent quarterly reports.

**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.

**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 three and nine months ended September 30, 2007 and 2006, respectively. Diluted net earnings per share reflects the potential dilution that could occur if the Company's potential common stock was issued. As of September 30, 2007, 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 three and nine months ended September 30, 2007 and 2006, is presented below.

|  | For the Three Months       |           | For the Nine Months        |           |
|--|----------------------------|-----------|----------------------------|-----------|
|  | Ended September 30<br>2007 | 2006      | Ended September 30<br>2007 | 2006      |
| <i>(Dollars in thousands, except share and per share data)</i> |                            |           |                            |           |
| <b>Basic:</b>  |                            |           |                            |           |
| Net earnings   | \$ 1,749                   | \$ 1,661  | \$ 5,138                   | \$ 5,038  |
| Average common shares outstanding                              | 3,708,097                  | 3,775,649 | 3,725,744                  | 3,781,918 |
| Earnings per share   | \$ 0.47                    | \$ 0.44   | \$ 1.38                    | \$ 1.33   |
| <b>Diluted:</b>  |                            |           |                            |           |
| Net earnings   | \$ 1,749                   | \$ 1,661  | \$ 5,138                   | \$ 5,038  |
| Average common shares outstanding                              | 3,708,097                  | 3,775,649 | 3,725,744                  | 3,781,918 |
| Dilutive effect of options issued                              |                            | 374       |                            | 445       |
| Average diluted shares outstanding                             | 3,708,097                  | 3,776,023 | 3,725,744                  | 3,782,363 |

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|                    |    |      |    |      |    |      |    |      |
|--------------------|----|------|----|------|----|------|----|------|
| Earnings per share | \$ | 0.47 | \$ | 0.44 | \$ | 1.38 | \$ | 1.33 |
|--------------------|----|------|----|------|----|------|----|------|

**Table of Contents****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 three and nine months ended September 30, 2007 and 2006, is presented below.

| <i>(In thousands)</i>  | <b>For the Three Months</b>        |                 | <b>For the Nine Months</b>         |                 |
|--|------------------------------------|-----------------|------------------------------------|-----------------|
|  | <b>Ended September 30<br/>2007</b> | <b>2006</b>     | <b>Ended September 30<br/>2007</b> | <b>2006</b>     |
| <b>Comprehensive income:</b>   |                                    |                 |                                    |                 |
| Net earnings   | \$ 1,749                           | \$ 1,661        | \$ 5,138                           | \$ 5,038        |
| <b>Other comprehensive income:</b>   |                                    |                 |                                    |                 |
| Change in unrealized loss on securities available for sale and derivative, net | 3,011                              | 2,116           | 286                                | 408             |
| <b>Total comprehensive income</b>  | <b>\$ 4,760</b>                    | <b>\$ 3,777</b> | <b>\$ 5,424</b>                    | <b>\$ 5,446</b> |

**NOTE 4: SECURITIES HELD-TO-MATURITY AND AVAILABLE-FOR-SALE**

The amortized cost and fair value for securities held to maturity at September 30, 2007 by contractual maturity are presented below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment penalties.

| <i>(Dollars in thousands)</i>    | <b>September 30, 2007</b> |                         |                          |                           |                           | <b>Gross Unrealized<br/>Gains</b> | <b>Losses</b> | <b>Fair<br/>value</b> |
|----------------------------------|---------------------------|-------------------------|--------------------------|---------------------------|---------------------------|-----------------------------------|---------------|-----------------------|
|                                  | <b>1 year<br/>or less</b> | <b>1 to 5<br/>years</b> | <b>5 to 10<br/>years</b> | <b>After 10<br/>years</b> | <b>Amortized<br/>cost</b> |                                   |               |                       |
| <b>Held-to-maturity:</b>         |                           |                         |                          |                           |                           |                                   |               |                       |
| State and political subdivisions | \$                        |                         |                          | 328                       | 328                       |                                   |               | 328                   |
| Mortgage-backed securities       | 23                        |                         | 43                       | 40                        | 106                       | 1                                 |               | 107                   |
| <b>Total held-to-maturity</b>    | <b>\$ 23</b>              |                         | <b>43</b>                | <b>368</b>                | <b>434</b>                | <b>1</b>                          |               | <b>435</b>            |
| <b>Weighted average yield:</b>   |                           |                         |                          |                           |                           |                                   |               |                       |
| State and political subdivisions |                           |                         |                          | 6.74%                     | 6.74%                     |                                   |               |                       |
| Mortgage-backed securities       | 6.91%                     |                         | 6.91%                    | 6.10%                     | 6.60%                     |                                   |               |                       |
| <b>Total held-to-maturity</b>    | <b>6.91%</b>              |                         | <b>6.91%</b>             | <b>6.67%</b>              | <b>6.71%</b>              |                                   |               |                       |

The fair value and amortized cost for securities available-for-sale at September 30, 2007, by contractual maturity are presented below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment penalties.

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| <i>(Dollars in thousands)</i>                                     | September 30, 2007 |                 |                  |                   |                | Gross Unrealized |              | Amortized<br>cost |
|---|--------------------|-----------------|------------------|-------------------|----------------|------------------|--------------|-------------------|
|   | 1 year<br>or less  | 1 to 5<br>years | 5 to 10<br>years | After 10<br>years | Fair<br>Value  | Gains            | Losses       |                   |
| <b>Available-for-sale:</b>  |                    |                 |                  |                   |                |                  |              |                   |
| U.S. government agencies, excluding<br>mortgage-backed securities | \$ 6,452           | 18,948          | 36,789           | 32,198            | 94,387         | 392              | 397          | 94,392            |
| State and political subdivisions                                  | 431                | 84              | 9,468            | 43,256            | 53,239         | 416              | 371          | 53,194            |
| Corporate securities  |                    |                 | 3,525            | 7,381             | 10,906         | 94               | 118          | 10,930            |
| Collateralized mortgage obligations                               |                    |                 | 2,446            | 10,128            | 12,574         | 29               | 278          | 12,823            |
| Mortgage-backed securities  |                    | 13,337          | 21,755           | 81,827            | 116,919        | 5                | 3,187        | 120,101           |
| <b>Total available-for-sale</b>                                   | <b>\$ 6,883</b>    | <b>32,369</b>   | <b>73,983</b>    | <b>174,790</b>    | <b>288,025</b> | <b>936</b>       | <b>4,351</b> | <b>291,440</b>    |
| <b>Weighted average yield:</b>                                    |                    |                 |                  |                   |                |                  |              |                   |
| U.S. government agencies, excluding<br>mortgage-backed securities | 3.75%              | 4.48%           | 5.20%            | 5.82%             | 5.16%          |                  |              |                   |
| State and political subdivisions                                  | 3.62%              | 7.64%           | 6.02%            | 6.12%             | 6.09%          |                  |              |                   |
| Corporate securities  |                    |                 | 6.54%            | 7.13%             | 6.94%          |                  |              |                   |
| Collateralized mortgage obligations                               |                    |                 | 4.01%            | 5.00%             | 4.81%          |                  |              |                   |
| Mortgage-backed securities  |                    | 3.90%           | 3.64%            | 4.96%             | 4.59%          |                  |              |                   |
| <b>Total available-for-sale</b>                                   | <b>3.74%</b>       | <b>4.25%</b>    | <b>4.87%</b>     | <b>5.50%</b>      | <b>5.15%</b>   |                  |              |                   |

Securities with an aggregate fair value of \$180.0 million and \$190.8 million at September 30, 2007 and December 31, 2006, respectively, were pledged to secure public and trust deposits as required by law and for other purposes.

Yields related to tax-exempt securities are stated on a fully tax-equivalent basis using an income tax rate of 34%.

On a quarterly basis, the Company 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. 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; recent events specific to the issuer or industry; external credit ratings and recent downgrades. 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).

Gross unrealized losses on securities at September 30, 2007 were attributable to interest rate changes and not attributable to credit quality. The Company has reviewed these securities and does not consider them other-than-temporarily impaired.

Gross gains realized on the sale of securities during the three months ended September 30, 2007 were \$5 thousand. Gross gains and losses realized on the sale of securities during the nine months ended September 30, 2007 were \$19 thousand and \$602 thousand, respectively.

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The amortized cost and fair value for securities held to maturity at December 31, 2006 by contractual maturity are presented below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment penalties.

| <i>(Dollars in thousands)</i>    | December 31, 2006 |              |               |                |                | Gross Unrealized Gains | Unrealized Losses | Fair value |
|----------------------------------|-------------------|--------------|---------------|----------------|----------------|------------------------|-------------------|------------|
|                                  | 1 year or less    | 1 to 5 years | 5 to 10 years | After 10 years | Amortized cost |                        |                   |            |
| <b>Held-to-maturity:</b>         |                   |              |               |                |                |                        |                   |            |
| State and political subdivisions | \$                |              |               | 340            | 340            |                        |                   | 340        |
| Mortgage-backed securities       | 10                | 59           | 27            | 77             | 173            | 1                      |                   | 174        |
| Total held-to-maturity           | \$ 10             | 59           | 27            | 417            | 513            | 1                      |                   | 514        |
| <b>Weighted average yield:</b>   |                   |              |               |                |                |                        |                   |            |
| State and political subdivisions |                   |              |               | 3.69%          | 3.69%          |                        |                   |            |
| Mortgage-backed securities       | 7.86%             | 7.03%        | 7.19%         | 5.91%          | 6.60%          |                        |                   |            |
| Total held-to-maturity           | 7.86%             | 7.03%        | 7.19%         | 4.10%          | 4.67%          |                        |                   |            |

The fair value and amortized cost for securities available-for-sale at December 31, 2006, by contractual maturity are presented below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment penalties.

| <i>(Dollars in thousands)</i>                                  | December 31, 2006 |              |               |                |            | Gross Unrealized Gains | Unrealized Losses | Amortized cost |
|--|-------------------|--------------|---------------|----------------|------------|------------------------|-------------------|----------------|
|  | 1 year or less    | 1 to 5 years | 5 to 10 years | After 10 years | Fair Value |                        |                   |                |
| <b>Available-for-sale:</b>                                     |                   |              |               |                |            |                        |                   |                |
| U.S. government agencies, excluding mortgage-backed securities | \$                | 43,412       | 37,409        | 19,287         | 100,108    | 194                    | 809               | 100,723        |
| State and political subdivisions                               |                   | 511          | 3,362         | 45,645         | 49,518     | 655                    | 69                | 48,932         |
| Corporate securities   |                   |              | 3,449         | 7,137          | 10,586     | 51                     | 170               | 10,705         |
| Collateralized mortgage obligations                            |                   |              | 1,518         | 13,195         | 14,713     | 34                     | 300               | 14,979         |
| Mortgage-backed securities                                     |                   | 16,701       | 35,320        | 74,478         | 126,499    | 204                    | 3,682             | 129,977        |
| Total available-for-sale                                       | \$                | 60,624       | 81,058        | 159,742        | 301,424    | 1,138                  | 5,030             | 305,316        |
| <b>Weighted average yield:</b>                                 |                   |              |               |                |            |                        |                   |                |
| U.S. government agencies, excluding mortgage-backed securities |                   | 3.98%        | 4.92%         | 7.19%          | 4.94%      |                        |                   |                |
| State and political subdivisions                               |                   |              | 4.19%         | 6.05%          | 6.04%      |                        |                   |                |
| Corporate securities   |                   |              | 6.53%         | 7.15%          | 6.95%      |                        |                   |                |
| Collateralized mortgage obligations                            |                   |              | 3.88%         | 4.87%          | 4.77%      |                        |                   |                |
| Mortgage-backed securities                                     |                   | 3.68%        | 3.66%         | 4.82%          | 4.34%      |                        |                   |                |
| Total available-for-sale                                       |                   | 3.86%        | 4.39%         | 5.57%          | 4.93%      |                        |                   |                |

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**NOTE 5: INCOME TAXES**

In June 2006, the FASB issued FIN 48, which clarifies the accounting for uncertain income tax positions by providing guidance on recognition, derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted FIN 48 on January 1, 2007, and determined there was no need to make an adjustment to retained earnings upon adoption of this Interpretation. As of January 1, 2007, the Company had \$658 thousand of unrecognized tax benefits related to state income tax matters. If ultimately recognized, this amount will impact the Company's effective tax rate. The Company recognizes accrued interest and penalties, as appropriate, related to unrecognized income tax benefits in the effective tax rate. Accrued interest and penalties were \$70 thousand as of January 1, 2007. There were no material changes in accrued interest and penalties through September 30, 2007.

Management monitors tax law, regulations and cases to determine the potential impact to uncertain tax positions. At September 30, 2007, management had not identified any potential subsequent events that would have a material impact on unrecognized income tax benefits within the next twelve months.

The Company and its subsidiaries file a consolidated U.S. federal income tax return. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending December 31, 2004 through 2006.

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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 consolidated financial statements for the three and nine months ended September 30, 2007 and 2006, as well as the information contained in our annual report on Form 10-K for the year ended December 31, 2006 and subsequent quarterly reports.

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, indicate, would, believe, continue, expect, seek, estimate, continue, plan, point to, project, predict, could, intend, target, potential, and other similar words in the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation:

future economic and business conditions;

government monetary and fiscal policies;

the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values of loan collateral, securities, and interest sensitive assets and liabilities;

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

credit risks;

uncertainties regarding assumptions underlying the establishment of allowance for possible loan losses and other estimates;

uncertainties regarding mergers and acquisitions, including, without limitation, the related costs and time of integrating operations as part of these transactions and the failure to achieve expected gains, revenue growth and/or expense savings from such transactions;

changes in laws and regulations, including tax, banking and securities laws and regulations;

changes in accounting policies, rules and practices;

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

the effects of war or other conflicts, acts of terrorism or other catastrophic events that may affect general economic conditions and economic confidence; 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, 2006 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.

**Table of Contents****Business**

Auburn National Bancorporation, Inc. is a bank holding company established in 1984, and incorporated under the laws of the State of Delaware. AuburnBank, 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, Mountain Brook and Orange Beach, Alabama.

**Summary of Results of Operations**

|   | For the Three Months<br>Ended September 30 |          | For the Nine Months<br>Ended September 30 |           |
|---|--|----------|---|-----------|
|   | 2007                                       | 2006     | 2007                                      | 2006      |
| <i>(Dollars in thousands, except per share amounts)</i> |  |          |   |           |
| Net interest income (GAAP)                              | \$ 4,324                                   | \$ 4,126 | \$ 12,577                                 | \$ 12,153 |
| Tax-equivalent adjustment                               | 286  | 248      | 832                                       | 782       |
| Net interest income (a)                                 | 4,610                                      | 4,374    | 13,409                                    | 12,935    |
| Noninterest income                                      | 1,088                                      | 1,090    | 3,414                                     | 3,358     |
| Total revenue (a)                                       | 5,698                                      | 5,464    | 16,823                                    | 16,293    |
| Provision for loan losses                               |  | 85       | 23  | 295       |
| Noninterest expense                                     | 3,074                                      | 2,849    | 9,107                                     | 8,429     |
| Income tax expense                                      | 589  | 621      | 1,723                                     | 1,749     |
| Tax-equivalent adjustment                               | 286  | 248      | 832                                       | 782       |
| Net earnings  | 1,749                                      | 1,661    | 5,138                                     | 5,038     |
| Basic and diluted earnings per share                    | \$ 0.47                                    | \$ 0.44  | \$ 1.38                                   | \$ 1.33   |

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

**Financial Summary**

The Company's net earnings were \$5.1 million for the first nine months of 2007 compared to \$5.0 million for the first nine months of 2006. Basic and diluted earnings per share were up 4% to \$1.38 per share.

Total tax-equivalent revenue increased 3% to \$16.8 million for the first nine months of 2007 compared to the same period in 2006. The increase in total revenue was driven by an increase in tax-equivalent net interest income of 4% for the first nine months of 2007, reflecting loan growth from the same period in 2006.

Credit quality continued to be very strong, with an annualized net recoveries ratio of 0.01%. As of September 30, 2007, nonperforming assets were 0.14% of total loans. Provision for loan losses decreased \$272 thousand during the first nine months of 2007 from the same period in 2006 due to continued strength in credit quality trends and a decrease in net charge-offs.

Average loans and loans held for sale increased 4% in the first nine months of 2007 from the first nine months of 2006 to \$298.2 million. Average total deposits increased 5% in the first nine months of 2007 from the first nine months of 2006 to \$487.0 million.

Noninterest expense increased 8% in the first nine months of 2007 from the first nine months of 2006, largely reflecting increases in salaries and benefits expense and professional fees expense.

In the first nine months of 2007, the Company paid cash dividends of \$2.0 million, or \$0.525 per share. In



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the first nine months of 2007, our dividend payout ratio was 38.04%. The Company's balance sheet remains strong and well capitalized under regulatory guidelines with a tier 1 capital ratio of 14.85% and a leverage ratio of 9.13% at September 30, 2007.

In the third quarter of 2007 net earnings were \$1.75 million compared to \$1.66 million for the third quarter of 2006. Basic and diluted earnings per share were up 7% to \$0.47 per share. Total tax-equivalent revenue increased 4% to \$5.7 million in the third quarter of 2007 compared with the third quarter of 2006, with 5% growth in tax-equivalent net interest income. Net interest income growth was driven by loan growth in the third quarter of 2007 compared to the third quarter of 2006. Provision for loan losses decreased \$85 thousand due to a decrease in net charge-offs. Noninterest expense increased 8% in the third quarter of 2007 compared to the third quarter of 2006, reflecting increases in salaries and benefits expense and other noninterest expense.

**Critical Accounting Policies**

The accounting and financial policies of the Company conform to U.S. generally accepted accounting principles and to general practices within the banking industry. The allowance for loan losses is an accounting policy applied by the Company which is deemed critical. Critical accounting policies are defined as policies which are important to the portrayal of the Company's financial condition and results of operations, and that require management's most difficult, subjective or complex judgments. These estimates and judgments involve significant uncertainties, and are susceptible to change. If different conditions exist or occur, and depending upon the magnitude of the changes, then our actual financial condition and financial results could differ significantly. See ALLOWANCE FOR LOAN LOSSES AND RISK ELEMENTS. For a more detailed discussion on these critical accounting policies, see CRITICAL ACCOUNTING POLICIES on pages 22-23 of the Company's annual report on Form 10-K for the year ended December 31, 2006.

**Average Balance Sheet and Interest Rates**

|   | Nine Months Ended September 30, |                |                    |                |
|---|---------------------------------|----------------|--------------------|----------------|
|   | 2007                            |                | 2006               |                |
| <i>(Dollars in thousands)</i>   | Average<br>Balance              | Yield/<br>Rate | Average<br>Balance | Yield/<br>Rate |
| Loans and loans held for sale   | \$ 298,236                      | 8.13%          | \$ 287,820         | 7.77%          |
| Securities - taxable  | 243,983                         | 4.95%          | 240,036            | 4.48%          |
| Securities - tax-exempt   | 51,495                          | 6.37%          | 48,311             | 6.38%          |
| Total securities  | 295,478                         | 5.20%          | 288,347            | 4.80%          |
| Federal funds sold  | 4,023                           | 5.32%          | 7,000              | 4.77%          |
| Interest bearing bank deposits  | 783                             | 4.61%          | 728                | 4.59%          |
| Total interest-earning assets   | 598,520                         | 6.66%          | 583,895            | 6.26%          |
| Deposits:   |                                 |                |                    |                |
| NOW   | 58,929                          | 2.31%          | 67,184             | 2.50%          |
| Savings and money market  | 144,930                         | 3.84%          | 142,346            | 3.60%          |
| Certificates of deposits less than \$100,000                          | 85,249                          | 5.29%          | 84,463             | 4.43%          |
| Certificates of deposits and other time deposits of \$100,000 or more | 126,928                         | 4.41%          | 102,277            | 3.73%          |
| Total interest-bearing deposits                                       | 416,036                         | 4.10%          | 396,270            | 3.62%          |
| Short-term borrowings   | 13,756                          | 5.03%          | 6,367              | 4.81%          |
| Long-term debt  | 90,492                          | 4.62%          | 104,587            | 4.41%          |
| Total interest-bearing liabilities                                    | 520,284                         | 4.21%          | 507,224            | 3.80%          |
| Net interest income and margin  | \$ 13,409                       | 3.00%          | \$ 12,935          | 2.96%          |

**Results of Operations****Net Interest Income and Margin**

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Tax-equivalent net interest income increased 4% in the first nine months of 2007 from the first nine months of 2006 as a result of loan growth. Net interest margin increased 4 basis points to 3.00%.

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The tax-equivalent yield on total interest earning assets increased 40 basis points in the first nine months of 2007 from the first nine months of 2006, to 6.66%. This increase was comprised of a 36 basis point increase in the yield on loans and loans held for sale to 8.13% and a 40 basis point increase in the tax-equivalent yield on total securities to 5.20%.

The cost of total interest-bearing liabilities increased 41 basis points in the first nine months of 2007 from the first nine months of 2006, to 4.21%. This increase was comprised of a 48 basis point increase in the cost of total interest-bearing deposits to 4.10%, a 22 basis point increase in the cost of short-term borrowings to 5.03% and a 21 basis point increase in the cost of long-term debt to 4.62%. The average federal funds rate during the first nine months of 2007 was 32 basis points higher than the average for the same period in 2006.

| <b>Noninterest Income</b>           | <b>For the Three Months</b> |                 | <b>For the Nine Months</b> |                 |
|-------------------------------------|-----------------------------|-----------------|----------------------------|-----------------|
|                                     | <b>Ended September 30</b>   |                 | <b>Ended September 30</b>  |                 |
| <i>(Dollars in thousands)</i>       | <b>2007</b>                 | <b>2006</b>     | <b>2007</b>                | <b>2006</b>     |
| Service charges on deposit accounts | \$ 325                      | \$ 356          | \$ 969                     | \$ 1,048        |
| Servicing fees                      | 82                          | 93              | 256                        | 284             |
| Gain on sale of loans held for sale | 157                         | 154             | 527                        | 474             |
| Bank-owned life insurance           | 135                         | 105             | 416                        | 341             |
| Securities gains (losses), net      | 5                           | (37)            | 29                         | 6               |
| Other                               | 384                         | 419             | 1,217                      | 1,205           |
| <b>Total noninterest income</b>     | <b>\$ 1,088</b>             | <b>\$ 1,090</b> | <b>\$ 3,414</b>            | <b>\$ 3,358</b> |

**Noninterest Income**

The major components of noninterest income are service charges on deposit accounts, servicing fees, gain on sale of loans held for sale, income from bank-owned life insurance, securities gains, net, and other noninterest income.

Noninterest income increased 2% or \$56 thousand in the first nine months of 2007 compared to the same period in 2006. Overall, there were no material changes in the first nine months of 2007 compared to the same period in 2006 among the major components of noninterest income.

There were no material changes in the third quarter of 2007 compared to the same period in 2006 among the major components of noninterest income.

| <b>Noninterest Expense</b>       | <b>For the Three Months</b> |                 | <b>For the Nine Months</b> |                 |
|----------------------------------|-----------------------------|-----------------|----------------------------|-----------------|
|                                  | <b>Ended September 30</b>   |                 | <b>Ended September 30</b>  |                 |
| <i>(Dollars in thousands)</i>    | <b>2007</b>                 | <b>2006</b>     | <b>2007</b>                | <b>2006</b>     |
| Salaries and benefits            | \$ 1,813                    | \$ 1,720        | \$ 5,371                   | \$ 5,078        |
| Net occupancy and equipment      | 328                         | 295             | 945                        | 881             |
| Professional fees                | 144                         | 109             | 497                        | 354             |
| Other                            | 789                         | 725             | 2,294                      | 2,116           |
| <b>Total noninterest expense</b> | <b>\$ 3,074</b>             | <b>\$ 2,849</b> | <b>\$ 9,107</b>            | <b>\$ 8,429</b> |

**Noninterest Expense**

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

Noninterest expense increased 8% or \$678 thousand in the first nine months of 2007 compared to the



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same period in 2006. This increase was primarily driven by increases in salaries and benefits expense and professional fees expense. Salaries and benefits increased \$293 thousand during the first nine months of 2007, due to normal increases in salaries and benefits costs, increases in commissions related to mortgage origination activity, and the hiring of additional mortgage originators in our loan production offices. Professional fees increased \$143 thousand during the first nine months of 2007 due to increased legal fees and costs associated with regulatory compliance.

Noninterest expense increased 8% or \$225 thousand in the third quarter of 2007 from the third quarter of 2006 due to the same factors as above.

## **Income Tax Expense**

Income tax expense was \$1.7 million, respectively, for the first nine months of 2007 and the first nine months of 2006. As a result, the Company's effective tax rate of 25.11% for the first nine months of 2007 was consistent with the same period last year.

In the third quarter of 2007 compared to the third quarter of 2006, there was no material change in income tax expense. The Company's effective tax rate for the third quarter of 2007 was 25.19%, compared to 27.21% for the third quarter of 2006. The decrease in the effective tax rate was due to increases in earnings from tax-exempt municipal obligations and bank-owned life insurance.

## **Balance Sheet Analysis**

### **Securities**

Securities held-to-maturity were \$434 thousand and \$513 thousand as of September 30, 2007 and December 31, 2006, respectively. The decrease from December 31, 2006 was primarily the result of scheduled paydowns and calls of principal amounts.

Securities available-for-sale were \$288.0 million and \$301.4 million as of September 30, 2007 and December 31, 2006, respectively. The decrease from December 31, 2006 was primarily the result of scheduled paydowns and calls of principal amounts. Unrealized net losses on securities available-for-sale were \$3.4 million and \$3.9 million as of September 30, 2007 and December 31, 2006, respectively. The unrealized net losses on securities available-for-sale were attributable to interest rates and not credit quality. The decrease in unrealized net losses of \$0.5 million from December 31, 2006 was due to changes in interest rates.

The average yield earned on total securities was 5.20% in the first nine months of 2007 and 4.80% in the first nine months of 2006.

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| Loans<br>(Dollars in thousands)        | For the Three Months Ended |                  |                   |                      | September 30,<br>2006 |
|--|----------------------------|------------------|-------------------|----------------------|-----------------------|
|  | September 30,<br>2007      | June 30,<br>2007 | March 31,<br>2007 | December 31,<br>2006 |                       |
| Commercial, financial and agricultural | \$ 56,659                  | 54,597           | 50,421            | 52,589               | 49,494                |
| Leases - commercial                    | 513                        | 646              | 713               | 762                  | 828                   |
| Real estate - construction:            |                            |                  |                   |                      |                       |
| Commercial                             | 10,282                     | 9,096            | 5,137             | 4,684                | 2,912                 |
| Residential                            | 13,420                     | 12,611           | 10,067            | 9,912                | 8,679                 |
| Real estate - mortgage:                |                            |                  |                   |                      |                       |
| Commercial                             | 157,072                    | 151,591          | 144,672           | 142,092              | 148,321               |
| Residential                            | 66,957                     | 63,121           | 61,706            | 62,596               | 63,638                |
| Consumer installment                   | 11,892                     | 11,619           | 10,121            | 9,348                | 9,874                 |
| Total loans                            | 316,795                    | 303,281          | 282,837           | 281,983              | 283,746               |
| Less: Allowance for Loan Losses        | (4,074)                    | (4,104)          | (4,123)           | (4,044)              | (4,038)               |
| Loans, net                             | \$ 312,721                 | 299,177          | 278,714           | 277,939              | 279,708               |

**Loans**

Total loans were \$316.8 million as of September 30, 2007, an increase of \$34.8 million or 12% from \$282.0 million at December 31, 2006. Growth in construction and commercial real estate mortgage loans were the primary drivers of the increase. As of September 30, 2007, construction loans and commercial real estate mortgage loans increased \$9.1 million and \$15.0 million, respectively from December 31, 2006.

Three loan categories represented the majority of the loan portfolio as of September 30, 2007. Commercial real estate mortgage loans represented 50%, residential real estate mortgage loans represented 21% and commercial, financial and agricultural loans represented 18% of the Bank's total loans at September 30, 2007.

The average yield earned on loans and loans held for sale was 8.13% in the first nine months of 2007 and 7.77% in the first nine months of 2006.

**Allowance for Loan Losses and Risk Elements**

The allowance for loan losses reflects management's assessments and estimates of the risks associated with extending credit and its evaluation of the quality of the Company's loan portfolio. Management reviews the components of the loan portfolio in order to estimate the appropriate provision required to maintain the allowance at a level believed adequate in relation to losses inherent in the loan portfolio. In assessing the allowance, management reviews the size, quality and risk of loans in the portfolio. Management also considers such factors as the Bank's loan loss experience, the amount of past due and nonperforming loans, specific known risks, the status, amounts, and values of nonperforming assets (including loans), underlying collateral values securing loans, current and anticipated economic conditions, anticipated developments with respect to various credits, and other factors which management believes affect the allowance for loan losses.

The Company's policy generally is to place a loan on nonaccrual status when it is contractually past due 90 days or more in payment of principal or interest. A loan may be placed on nonaccrual status at an earlier date if concerns exist as to the ultimate collectability of principal or interest. At the time a loan is placed on nonaccrual status, interest previously accrued but not collected is reversed and charged against current earnings. Loans that are contractually past due 90 days or more, which are well secured and in the process of collection, are generally not placed on nonaccrual status.

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A summary of the changes in the allowance for loan losses during the third quarter of 2007 and the previous four quarters are presented below.

| Allowance for loan losses<br>(Dollars in thousands) | For the Three Months Ended |                  |                   |                      |                       |
|---|----------------------------|------------------|-------------------|----------------------|-----------------------|
|   | September 30,<br>2007      | June 30,<br>2007 | March 31,<br>2007 | December 31,<br>2006 | September 30,<br>2006 |
| Balance at beginning of period                      | \$ 4,104                   | 4,123            | 4,044             | 4,038                | 3,988                 |
| Charge-offs   | (36)                       | (119)            |                   | (39)                 | (57)                  |
| Recoveries  | 6                          | 80               | 76                | 10                   | 22                    |
| Net (charge-offs) recoveries                        | (30)                       | (39)             | 76                | (29)                 | (35)                  |
| Provision for loan losses                           |                            | 20               | 3                 | 35                   | 85                    |
| Ending balance                                      | \$ 4,074                   | 4,104            | 4,123             | 4,044                | 4,038                 |

The allowance for loan losses increased 1% from December 31, 2006 to \$4.1 million as of September 30, 2007. Management believes that the current level of allowance for loan losses (1.29% of total outstanding loans at September 30, 2007) is adequate to absorb anticipated losses identified in the portfolio at September 30, 2007. No assurance can be given, however, that adverse economic circumstances or other events, including additional loan review or examination findings or changes in borrowers' financial conditions, will not result in increased losses in the Bank's loan portfolio or in additional provision to the allowance for loan losses.

**Provision for Loan Losses**

During the first nine months of 2007, the Company recorded a total provision for loan losses of \$23 thousand based on management's reviews and assessments of the factors discussed above. The provision for loan losses decreased \$272 thousand in the first nine months of 2007 from the same period in 2006, primarily due to continued strength in credit quality trends and a decrease in net charge-offs.

**Nonperforming Assets**

Nonperforming assets, comprised of nonaccrual loans, other nonperforming assets, and accruing loans 90 days or more past due, increased by \$375 thousand to \$447 thousand as of September 30, 2007. The increase in nonperforming assets was a result of increases in nonaccrual loans and accruing loans 90 days or more past due. As of September 30, 2007, nonperforming assets were 0.14% of total loans. If nonaccrual loans had performed in accordance with their original contractual terms, interest income would have increased by approximately \$8 thousand for the nine months ended September 30, 2007.

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

| Nonperforming assets<br>(In thousands)                         | For the Three Months Ended |                  |                   |                      |                       |
|--|----------------------------|------------------|-------------------|----------------------|-----------------------|
|  | September 30,<br>2007      | June 30,<br>2007 | March 31,<br>2007 | December 31,<br>2006 | September 30,<br>2006 |
| Nonaccrual loans   | \$ 392                     | 7                | 230               | 72                   | 17                    |
| Other nonperforming assets (primarily other real estate owned) |                            |                  |                   |                      |                       |
| Accruing loans 90 days or more past due                        | 55                         |                  |                   |                      |                       |
| Total nonperforming assets                                     | \$ 447                     | 7                | 230               | 72                   | 17                    |
| as a % of loans  | 0.14%                      | 0.00             | 0.08              | 0.03                 | 0.01                  |

Potential problem loans consist of those loans where management has serious doubt as to the borrower's ability to comply with the contractual loan repayment terms. At September 30, 2007, 59 loans totaling \$5.1 million



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or 1.6% of total loans outstanding, net of unearned income, were considered potential problem loans compared to 61 loans totaling \$5.2 million or 1.8% of total loans at December 31, 2006. At September 30, 2007 and December 31, 2006, the Company had no impaired loans.

### **Deposits**

Total deposits were \$510.1 million and \$469.6 million at September 30, 2007 and December 31, 2006, respectively. The increase of \$40.5 million in total deposits from December 31, 2006 was largely due to increases in CDs over \$100,000. CDs over \$100,000 increased \$44.6 million or 40% from December 31, 2006. This increase was primarily driven by a \$25.2 million increase in brokered CDs, an alternative source of cost-effective funding. The remainder of the increase was primarily driven by increases in public and trust deposits.

The average rate paid on total interest-bearing deposits was 4.10% in the first nine months of 2007 and 3.62% in the first nine months of 2006.

Noninterest bearing deposits were 15% and 17% of total deposits as of September 30, 2007 and December 31, 2006, respectively.

### **Other Borrowings**

Other borrowings consist of federal funds purchased, securities sold under agreements to repurchase, other short-term borrowings, and long-term debt. The Bank had available federal fund lines totaling \$42.0 million with none outstanding at September 30, 2007, compared to \$34.3 million and \$7.7 million outstanding at December 31, 2006. Securities sold under agreements to repurchase totaled \$7.6 million at September 30, 2007, compared to \$6.7 million at December 31, 2006.

Other short-term borrowings included FHLB borrowings with an original maturity of one year or less. In February of 2007, short-term FHLB borrowings of \$10.0 million were repaid. The Company replaced the short-term FHLB borrowings with brokered CDs, an alternative source of cost-effective funding.

The average rate paid on short-term borrowings was 5.03% in the first nine months of 2007 and 4.81% in the first nine months of 2006.

Long-term debt included FHLB borrowings with an original maturity great than one year and subordinated debentures related to trust preferred securities. The Bank had \$83.2 million in long-term FHLB borrowings and \$7.2 million in subordinated debentures at September 30, 2007 and December 31, 2006.

The average rate paid on long-term debt was 4.62% in the first nine months of 2007 and 4.41% in the first nine months of 2006.

### **Liquidity**

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 for the Company includes dividends received from the Bank and proceeds from the issuance of common stock. Primary uses of funds for the Company include dividends paid to

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shareholders, stock repurchases, and interest payments on subordinated debentures related to trust preferred securities. The subordinated debentures are presented as long-term debt in the Consolidated Balance Sheets and are includible in Tier 1 Capital for regulatory capital purposes, subject to certain limitations.

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB's advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. As of September 30, 2007, the Bank had an available line of credit with the FHLB totaling \$197.1 million with \$83.2 million outstanding. As of September 30, 2007, the Bank also had \$42.0 million of federal funds lines with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

Management believes the Company's and the Bank's sources of liquidity are adequate to meet loan demand, operating needs, and deposit withdrawal requirements.

**Capital Adequacy**

The Company's consolidated stockholders' equity was \$50.5 million and \$48.4 million as of September 30, 2007 and December 31, 2006, respectively. The increase from December 31, 2006 was primarily a result of net earnings of \$5.1 million. This increase was offset by cash dividends of \$2.0 million or \$0.525 per share and \$1.4 million in stock repurchases.

The Company's Tier 1 leverage ratio was 9.13%, Tier 1 risk-based capital ratio was 14.85% and Total risk-based capital ratio was 15.86% at September 30, 2007. These ratios exceed the minimum regulatory capital percentages of 4.0% for Tier 1 leverage ratio, 4.0% for Tier 1 risk-based capital ratio and 8.0% for Total risk-based capital ratio. Based on current regulatory standards, the Company is classified as well capitalized.

**Off-Balance Sheet Arrangements**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such instruments involve elements of credit risk in excess of the amounts recognized in the consolidated financial statements.

The Company's exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and entering into conditional obligations as it does for on-balance sheet instruments.

The financial instruments with contract amounts which represent credit risk as of September 30, 2007 are as follows:

|                              |               |
|------------------------------|---------------|
| Commitments to extend credit | \$ 54,638,000 |
| Standby letters of credit    | 10,160,000    |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. Most standby letters of credit expire within one year, but may be renewed. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitment facilities to customers. The Company may hold various assets as collateral supporting those commitments, where it determines that collateral for these obligations is appropriate.

**Table of Contents****Interest Rate Sensitivity Management**

At September 30, 2007, interest sensitive assets that reprice or mature within the next 12 months were \$261.0 million compared to interest sensitive liabilities that reprice or mature within the same time frame totaling \$330.5 million. The cumulative GAP position (the difference between interest sensitive assets and interest sensitive liabilities) of a negative \$69.5 million resulted in a GAP ratio (calculated as interest sensitive assets divided by interest sensitive liabilities) of 79%. This compares to a twelve month cumulative GAP position at December 31, 2006, of a negative \$75.5 million and a GAP ratio of 76%. A negative GAP position indicates that the Company has more interest-bearing liabilities than interest-earning assets that reprice within the period measured, and that net interest income may be adversely affected in a rising rate environment as rates earned on interest-earning assets rise more slowly than rates paid on interest-bearing liabilities. A positive GAP position indicates that the Company has more interest-earning assets than interest-bearing liabilities that reprice within the period measured. The Bank's Asset/Liability Management Committee (ALCO) is charged with the responsibility of managing, to the degree prudently possible, the Company's exposure to interest rate risk, while attempting to provide earnings enhancement opportunities. The Bank's ALCO realizes that GAP is limited in scope since it does not capture all the options or repricing opportunities in the balance sheet. Therefore, ALCO places its emphasis on Income at Risk and Economic Value of Equity measurements. Based on alternative interest rate scenarios used by the Company in modeling for asset/liability planning purposes, the GAP position at September 30, 2007 and various assumptions and estimates, the Company's asset/liability model predicts that the changes in the Company's net interest income would be less than 10.0% when rates are gradually increased or decreased 200 basis points over 12 months. Such estimates and predictions are forecasts which may or may not be realized. See ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

**Effects of Inflation and Changing Prices**

Virtually all of the assets and liabilities of the Company are monetary in nature. As a result, interest rates have a more significant effect on the Company's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or with the same magnitude as the price of goods and services because such prices are affected by inflation. In the current interest rate environment, liquidity and the maturity structure of the Company's assets and liabilities are critical to the maintenance of desired performance levels.

**Pending and New Accounting Pronouncements**

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments. SFAS 155 is an amendment of SFAS 133 and SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. SFAS 155 permits companies to elect, on a deal-by-deal basis, to apply a fair-value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. The Company will be required to apply the provisions of SFAS 155 to all financial instruments acquired or issued after January 1, 2007. Adoption of SFAS 155 did not have a material impact on the consolidated financial statements of the Company.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement 140. SFAS 156 amends SFAS No. 140 with respect to the accounting for separately recognized servicing assets and liabilities. SFAS 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like accounting. SFAS 156 is effective as of the beginning of the first fiscal year that begins after September 15, 2006. Adoption of SFAS 156 did not have a material impact on the consolidated financial statements of the Company.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an

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interpretation of FASB Statement No. 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, or expected to be taken in a tax return, and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. Adoption of FIN 48 did not have a material impact on the consolidated financial statements of the Company.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. The statement does not require any new fair value measurements, however, does clarify the proper measurement of fair value as the hypothetical price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or receive the assumed liability (an entry price) at the measurement date. The Company will be required to adopt this standard beginning January 1, 2008. Management is currently evaluating this statement and its effect on the consolidated financial statements of the Company.

In September 2006, the FASB issued SFAS No. 158, An Amendment to Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. SFAS 158 requires the recognition on the balance sheet of the overfunded or underfunded status of a defined benefit postretirement obligation measured as the difference between the fair value of plan assets and the benefit obligation. Recognition of delayed items should be considered in other comprehensive income. This statement is effective for fiscal years ending after December 15, 2006. Adoption of SFAS No. 158 did not have any impact on the consolidated financial statements of the Company as the Company does not have any defined benefit pension or other postretirement plans.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, with early adoption permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, Fair Value Measurements. Management is currently evaluating this statement and its effect on the consolidated financial statements of the Company.

In November 2007, the SEC issued Staff Accounting Bulletin No. 109 ( SAB 109 ), Written Loan Commitments Recorded at Fair Value Through Earnings. SAB 109 rescinds SAB 105's prohibition on inclusion of expected net future cash flows related to loan servicing activities in the fair value measurement of a written loan commitment. SAB 109 also applies to any loan commitments for which fair value accounting is elected under SFAS 159. SAB 109 is effective prospectively for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Company is currently assessing the financial impact of adopting SAB 109.

**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 this non-GAAP financial measure enhances investors' understanding of its business and performance, this non-GAAP financial measure should not be considered an alternative to GAAP. The reconciliation of this non-GAAP financial measure from GAAP to non-GAAP is presented below.

| <i>(Dollars in thousands)</i>        | <b>For the Three Months<br/>Ended September 30</b> |             | <b>For the Nine Months<br/>Ended September 30</b> |             |
|--------------------------------------|--|-------------|---|-------------|
|                                      | <b>2007</b>  | <b>2006</b> | <b>2007</b>                                       | <b>2006</b> |
| Net interest income (GAAP)           | \$ 4,324   | \$ 4,126    | \$ 12,577   | \$ 12,153   |
| Tax-equivalent adjustment            | 286  | 248         | 832   | 782         |
| Net interest income (Tax-equivalent) | \$ 4,610   | \$ 4,374    | \$ 13,409   | \$ 12,935   |

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

| <i>(Dollars in thousands, except per share amounts)</i>        | For the Three Months Ended |                  |                   |                      |                       |
|--|----------------------------|------------------|-------------------|----------------------|-----------------------|
|  | September 30,<br>2007      | June 30,<br>2007 | March 31,<br>2007 | December 31,<br>2006 | September 30,<br>2006 |
| <b>Income statement</b>  |                            |                  |                   |                      |                       |
| Tax-equivalent interest income                                 | \$ 10,234                  | \$ 9,993         | \$ 9,575          | \$ 9,307             | \$ 9,441              |
| Total interest expense   | 5,624                      | 5,417            | 5,352             | 5,229                | 5,067                 |
| Tax equivalent net interest income                             | 4,610                      | 4,576            | 4,223             | 4,078                | 4,374                 |
| Provision for loan losses                                      |                            | 20               | 3                 | 35                   | 85                    |
| Total noninterest income                                       | 1,088                      | 1,138            | 1,188             | 1,090                | 1,090                 |
| Total noninterest expense                                      | 3,074                      | 3,130            | 2,903             | 2,772                | 2,849                 |
| Net earnings before income taxes and tax-equivalent adjustment | 2,624                      | 2,564            | 2,505             | 2,361                | 2,530                 |
| Tax-equivalent adjustment                                      | 286                        | 278              | 268               | 251                  | 248                   |
| Income tax expense   | 589                        | 575              | 559               | 563                  | 621                   |
| Net earnings   | \$ 1,749                   | \$ 1,711         | \$ 1,678          | \$ 1,547             | \$ 1,661              |
| <b>Per share data:</b>   |                            |                  |                   |                      |                       |
| Basic and diluted net earnings                                 | \$ 0.47                    | \$ 0.46          | \$ 0.45           | \$ 0.41              | \$ 0.44               |
| Cash dividends declared  | \$ 0.175                   | \$ 0.175         | \$ 0.175          | \$ 0.16              | \$ 0.16               |
| <b>Weighted average shares outstanding</b>                     |                            |                  |                   |                      |                       |
| Basic  | 3,708,097                  | 3,729,681        | 3,739,803         | 3,765,270            | 3,775,649             |
| Diluted  | 3,708,097                  | 3,729,681        | 3,739,803         | 3,765,270            | 3,776,023             |
| Shares outstanding   | 3,691,260                  | 3,727,260        | 3,735,703         | 3,743,787            | 3,771,568             |
| Book value   | \$ 13.68                   | \$ 12.69         | \$ 13.41          | \$ 12.93             | \$ 12.47              |
| <b>Common stock price</b>                                      |                            |                  |                   |                      |                       |
| High   | \$ 27.88                   | \$ 29.00         | \$ 29.82          | \$ 28.89             | \$ 27.01              |
| Low  | 23.25                      | 26.03            | 26.90             | 26.39                | 23.03                 |
| Period-end   | \$ 24.77                   | \$ 26.31         | \$ 28.01          | \$ 28.89             | \$ 27.01              |
| To earnings ratio  | 13.84x                     | 14.95x           | 15.91x            | 16.60x               | 15.09x                |
| To book value  | 181%                       | 207%             | 209%              | 223%                 | 217%                  |
| <b>Performance ratios:</b>                                     |                            |                  |                   |                      |                       |
| Return on average equity                                       | 14.41%                     | 13.03%           | 13.25%            | 12.96%               | 14.84%                |
| Return on average assets                                       | 1.07                       | 1.07             | 1.06              | 0.99                 | 1.06                  |
| Dividend payout ratio  | 37.23                      | 38.04            | 38.89             | 39.02                | 36.36                 |
| Average equity to average assets                               | 7.43                       | 8.19             | 7.98              | 7.60                 | 7.14                  |
| <b>Asset Quality:</b>  |                            |                  |                   |                      |                       |
| Allowance for loan losses as a % of:                           |                            |                  |                   |                      |                       |
| Loans  | 1.29%                      | 1.35%            | 1.46%             | 1.43%                | 1.42%                 |
| Nonperforming assets   | 911                        | 58,629           | 1,793             | 5,617                | 23,753                |
| Net charge-offs (recoveries) as a % of average loans           | 0.04                       | 0.05             | (0.11)            | 0.04                 | 0.05                  |
| Nonperforming assets as a % of loans                           | 0.14                       | 0.00             | 0.08              | 0.03                 | 0.01                  |
| <b>Capital Adequacy:</b>                                       |                            |                  |                   |                      |                       |
| Tier 1 capital ratio   | 14.85%                     | 15.46%           | 15.72%            | 15.59%               | 15.42%                |
| Total capital ratio  | 15.86                      | 16.50            | 16.82             | 16.68                | 16.49                 |
| Leverage ratio   | 9.13                       | 9.51             | 9.72              | 9.22                 | 9.20                  |
| <b>Other financial data:</b>                                   |                            |                  |                   |                      |                       |
| Net interest margin  | 3.02%                      | 3.07%            | 2.90%             | 2.76%                | 2.96%                 |
| Effective income tax rate                                      | 25.19                      | 25.15            | 24.99             | 26.68                | 27.21                 |
| Efficiency ratio (a)   | 53.95                      | 54.78            | 53.65             | 53.64                | 52.14                 |

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| <b>Selected period end balances:</b> |            |            |            |            |            |
|--------------------------------------|------------|------------|------------|------------|------------|
| Securities                           | \$ 288,459 | \$ 292,618 | \$ 297,323 | \$ 301,937 | \$ 287,703 |
| Loans                                | 316,795    | 303,281    | 282,837    | 281,983    | 283,746    |
| Allowance for loan losses            | 4,074      | 4,104      | 4,123      | 4,044      | 4,038      |
| Total assets                         | 661,780    | 651,822    | 643,515    | 635,126    | 635,987    |
| Total deposits                       | 510,078    | 490,478    | 493,218    | 469,648    | 479,269    |
| Long-term debt                       | 90,390     | 90,395     | 90,399     | 90,404     | 100,409    |
| Total stockholders' equity           | 50,503     | 47,305     | 50,089     | 48,418     | 47,025     |

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

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

| <i>(Dollars in thousands, except per share amounts)</i>        | <b>For the Nine Months Ended</b> |                               |
|--|----------------------------------|-------------------------------|
|  | <b>September 30,<br/>2007</b>    | <b>September 30,<br/>2006</b> |
| <b>Income statement</b>  |                                  |                               |
| Tax-equivalent interest income                                 | \$ 29,802                        | \$ 27,351                     |
| Total interest expense   | 16,393                           | 14,416                        |
| Tax equivalent net interest income                             | 13,409                           | 12,935                        |
| Provision for loan losses                                      | 23                               | 295                           |
| Total noninterest income                                       | 3,414                            | 3,358                         |
| Total noninterest expense                                      | 9,107                            | 8,429                         |
| Net earnings before income taxes and tax-equivalent adjustment | 7,693                            | 7,569                         |
| Tax-equivalent adjustment                                      | 832                              | 782                           |
| Income tax expense   | 1,723                            | 1,749                         |
| Net earnings   | \$ 5,138                         | \$ 5,038                      |
| <b>Per share data:</b>   |                                  |                               |
| Basic and diluted net earnings                                 | \$ 1.38                          | \$ 1.33                       |
| Cash dividends declared  | \$ 0.525                         | \$ 0.48                       |
| Weighted average shares outstanding                            |                                  |                               |
| Basic  | 3,725,744                        | 3,781,918                     |
| Diluted  | 3,725,744                        | 3,782,363                     |
| Shares outstanding   | 3,691,260                        | 3,771,568                     |
| Book value   | \$ 13.68                         | \$ 12.47                      |
| Common stock price   |                                  |                               |
| High   | \$ 27.88                         | \$ 27.01                      |
| Low  | 23.25                            | 23.03                         |
| Period-end   | \$ 24.77                         | \$ 27.01                      |
| To earnings ratio  | 13.84x                           | 15.09x                        |
| To book value  | 181%                             | 217%                          |
| <b>Performance ratios:</b>                                     |                                  |                               |
| Return on average equity                                       | 13.50%                           | 15.09%                        |
| Return on average assets                                       | 1.06                             | 1.08                          |
| Dividend payout ratio  | 38.04                            | 36.09                         |
| Average equity to average assets                               | 7.89                             | 7.05                          |
| <b>Asset Quality:</b>  |                                  |                               |
| Allowance for loan losses as a % of:                           |                                  |                               |
| Loans  | 1.29%                            | 1.42%                         |
| Nonperforming assets   | 911                              | 23,753                        |
| Net charge-offs (recoveries) as a % of average loans           | (0.01)                           | 0.05                          |
| Nonperforming assets as a % of loans                           | 0.14                             | 0.01                          |
| <b>Capital Adequacy:</b>                                       |                                  |                               |
| Tier 1 capital ratio   | 14.85%                           | 15.42%                        |
| Total capital ratio  | 15.86                            | 16.49                         |
| Leverage ratio   | 9.13                             | 9.20                          |
| <b>Other financial data:</b>                                   |                                  |                               |
| Net interest margin  | 3.00%                            | 2.96%                         |
| Effective income tax rate                                      | 25.11                            | 25.77                         |
| Efficiency ratio (a)   | 54.13                            | 51.73                         |
| <b>Selected period end balances:</b>                           |                                  |                               |

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|                            |            |            |
|----------------------------|------------|------------|
| Securities                 | \$ 288,459 | \$ 287,703 |
| Loans                      | 316,795    | 283,746    |
| Allowance for loan losses  | 4,074      | 4,038      |
| Total assets               | 661,780    | 635,987    |
| Total deposits             | 510,078    | 479,269    |
| Long-term debt             | 90,390     | 100,409    |
| Total stockholders' equity | 50,503     | 47,025     |

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

**Table of Contents****Table 4 - Average Balance and Net Interest Income Analysis**

| <i>(Dollars in thousands)</i>   | Three Months Ended September 30, |                              |            |                 |                              |            |
|---|----------------------------------|------------------------------|------------|-----------------|------------------------------|------------|
|   | Average Balance                  | 2007 Interest Income/Expense | Yield/Rate | Average Balance | 2006 Interest Income/Expense | Yield/Rate |
| <b>Interest-earning assets:</b>                                       |                                  |                              |            |                 |                              |            |
| Loans and loans held for sale (1)                                     | \$ 315,158                       | \$ 6,370                     | 8.02%      | \$ 292,509      | \$ 5,845                     | 7.93%      |
| Securities - taxable  | 235,287                          | 2,978                        | 5.02%      | 242,244         | 2,774                        | 4.54%      |
| Securities - tax-exempt (2)   | 52,782                           | 843                          | 6.34%      | 45,639          | 733                          | 6.37%      |
| Total securities  | 288,069                          | 3,821                        | 5.26%      | 287,883         | 3,507                        | 4.83%      |
| Federal funds sold  | 2,678                            | 38                           | 5.63%      | 5,843           | 77                           | 5.23%      |
| Interest bearing bank deposits  | 383                              | 5                            | 5.18%      | 904             | 12                           | 5.27%      |
| Total interest-earning assets   | 606,288                          | \$ 10,234                    | 6.70%      | 587,139         | \$ 9,441                     | 6.38%      |
| Cash and due from banks   | 13,514                           |                              |            | 13,348          |                              |            |
| Other assets  | 33,873                           |                              |            | 26,920          |                              |            |
| Total assets  | \$ 653,675                       |                              |            | \$ 627,407      |                              |            |
| <b>Interest-bearing liabilities:</b>                                  |                                  |                              |            |                 |                              |            |
| Deposits:   |                                  |                              |            |                 |                              |            |
| NOW   | \$ 55,379                        | \$ 293                       | 2.10%      | \$ 62,224       | \$ 376                       | 2.40%      |
| Savings and money market  | 143,870                          | 1,328                        | 3.66%      | 144,392         | 1,350                        | 3.71%      |
| Certificates of deposits less than \$100,000                          | 86,136                           | 1,174                        | 5.41%      | 83,530          | 986                          | 4.68%      |
| Certificates of deposits and other time deposits of \$100,000 or more | 142,396                          | 1,607                        | 4.48%      | 110,016         | 1,121                        | 4.04%      |
| Total interest-bearing deposits                                       | 427,781                          | 4,402                        | 4.08%      | 400,162         | 3,833                        | 3.80%      |
| Short-term borrowings   | 13,114                           | 160                          | 4.84%      | 6,158           | 74                           | 4.77%      |
| Long-term debt  | 90,392                           | 1,062                        | 4.66%      | 103,345         | 1,160                        | 4.45%      |
| Total interest-bearing liabilities                                    | 531,287                          | \$ 5,624                     | 4.20%      | 509,665         | \$ 5,067                     | 3.94%      |
| Noninterest-bearing deposits  | 71,078                           |                              |            | 72,003          |                              |            |
| Other liabilities   | 2,766                            |                              |            | 967             |                              |            |
| Stockholders equity   | 48,544                           |                              |            | 44,772          |                              |            |
| Total liabilities and stockholders equity                             | \$ 653,675                       |                              |            | \$ 627,407      |                              |            |
| Net interest income and margin  |                                  | \$ 4,610                     | 3.02%      |                 | \$ 4,374                     | 2.96%      |

(1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.

(2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.

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

| <i>(Dollars in thousands)</i>   | Nine Months Ended September 30, |  |                |                    |  |                |
|---|---------------------------------|--|----------------|--------------------|--|----------------|
|   | Average<br>Balance              | 2007<br>Interest<br>Income/<br>Expense | Yield/<br>Rate | Average<br>Balance | 2006<br>Interest<br>Income/<br>Expense | Yield/<br>Rate |
| <b>Interest-earning assets:</b>                                       |                                 |  |                |                    |  |                |
| Loans and loans held for sale (1)                                     | \$ 298,236                      | \$ 18,128                              | 8.13%          | \$ 287,820         | \$ 16,728                              | 7.77%          |
| Securities - taxable  | 243,983                         | 9,035                                  | 4.95%          | 240,036            | 8,044                                  | 4.48%          |
| Securities - tax-exempt (2)   | 51,495                          | 2,452                                  | 6.37%          | 48,311             | 2,304                                  | 6.38%          |
| Total securities  | 295,478                         | 11,487                                 | 5.20%          | 288,347            | 10,348                                 | 4.80%          |
| Federal funds sold  | 4,023                           | 160                                    | 5.32%          | 7,000              | 250                                    | 4.77%          |
| Interest bearing bank deposits  | 783                             | 27                                     | 4.61%          | 728                | 25                                     | 4.59%          |
| Total interest-earning assets   | 598,520                         | \$ 29,802                              | 6.66%          | 583,895            | \$ 27,351                              | 6.26%          |
| Cash and due from banks   | 13,026                          |  |                | 13,250             |  |                |
| Other assets  | 31,856                          |  |                | 25,519             |  |                |
| Total assets  | \$ 643,402                      |  |                | \$ 622,664         |  |                |
| <b>Interest-bearing liabilities:</b>                                  |                                 |  |                |                    |  |                |
| Deposits:   |                                 |  |                |                    |  |                |
| NOW   | \$ 58,929                       | \$ 1,020                               | 2.31%          | \$ 67,184          | \$ 1,255                               | 2.50%          |
| Savings and money market  | 144,930                         | 4,163                                  | 3.84%          | 142,346            | 3,829                                  | 3.60%          |
| Certificates of deposits less than \$100,000                          | 85,249                          | 3,372                                  | 5.29%          | 84,463             | 2,797                                  | 4.43%          |
| Certificates of deposits and other time deposits of \$100,000 or more | 126,928                         | 4,191                                  | 4.41%          | 102,277            | 2,854                                  | 3.73%          |
| Total interest-bearing deposits                                       | 416,036                         | 12,746                                 | 4.10%          | 396,270            | 10,735                                 | 3.62%          |
| Short-term borrowings   | 13,756                          | 518                                    | 5.03%          | 6,367              | 229                                    | 4.81%          |
| Long-term debt  | 90,492                          | 3,129                                  | 4.62%          | 104,587            | 3,452                                  | 4.41%          |
| Total interest-bearing liabilities                                    | 520,284                         | \$ 16,393                              | 4.21%          | 507,224            | \$ 14,416                              | 3.80%          |
| Noninterest-bearing deposits  | 70,967                          |  |                | 69,453             |  |                |
| Other liabilities   | 1,403                           |  |                | 2,035              |  |                |
| Stockholders equity   | 50,748                          |  |                | 43,952             |  |                |
| Total liabilities and stockholders equity                             | \$ 643,402                      |  |                | \$ 622,664         |  |                |
| Net interest income and margin  |                                 | \$ 13,409                              | 3.00%          |                    | \$ 12,935                              | 2.96%          |

(1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.

(2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.

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

| <i>(Dollars in thousands)</i>          | For the Three Months Ended |                  |                   |                      | September 30,<br>2006 |
|--|----------------------------|------------------|-------------------|----------------------|-----------------------|
|  | September 30,<br>2007      | June 30,<br>2007 | March 31,<br>2007 | December 31,<br>2006 |                       |
| Commercial, financial and agricultural | \$ 56,659                  | 54,597           | 50,421            | 52,589               | 49,494                |
| Leases - commercial                    | 513                        | 646              | 713               | 762                  | 828                   |
| Real estate - construction:            |                            |                  |                   |                      |                       |
| Commercial                             | 10,282                     | 9,096            | 5,137             | 4,684                | 2,912                 |
| Residential                            | 13,420                     | 12,611           | 10,067            | 9,912                | 8,679                 |
| Real estate - mortgage:                |                            |                  |                   |                      |                       |
| Commercial                             | 157,072                    | 151,591          | 144,672           | 142,092              | 148,321               |
| Residential                            | 66,957                     | 63,121           | 61,706            | 62,596               | 63,638                |
| Consumer installment                   | 11,892                     | 11,619           | 10,121            | 9,348                | 9,874                 |
| Total loans                            | 316,795                    | 303,281          | 282,837           | 281,983              | 283,746               |
| Less: Allowance for Loan Losses        | (4,074)                    | (4,104)          | (4,123)           | (4,044)              | (4,038)               |
| Loans, net                             | \$ 312,721                 | 299,177          | 278,714           | 277,939              | 279,708               |

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

| <i>(Dollars in thousands)</i>                                  | September 30,<br>2007 | June 30,<br>2007 | March 31,<br>2007 | December 31,<br>2006 | September 30,<br>2006 |
|--|-----------------------|------------------|-------------------|----------------------|-----------------------|
| <b>Allowance for loan losses:</b>                              |                       |                  |                   |                      |                       |
| Balance at beginning of period                                 | \$ 4,104              | 4,123            | 4,044             | 4,038                | 3,988                 |
| Charge-offs  | (36)                  | (119)            |                   | (39)                 | (57)                  |
| Recoveries   | 6                     | 80               | 76                | 10                   | 22                    |
| Net (charge-offs) recoveries                                   | (30)                  | (39)             | 76                | (29)                 | (35)                  |
| Provision for loan losses                                      |                       | 20               | 3                 | 35                   | 85                    |
| Ending balance   | \$ 4,074              | 4,104            | 4,123             | 4,044                | 4,038                 |
| as a % of loans  | 1.29%                 | 1.35             | 1.46              | 1.43                 | 1.42                  |
| as a % of nonperforming assets                                 | 911%                  | 58,629           | 1,793             | 5,617                | 23,753                |
| Net charge-offs as a % of average loans                        | 0.04%                 | 0.05             | (0.11)            | 0.04                 | 0.05                  |
| <b>Nonperforming assets:</b>                                   |                       |                  |                   |                      |                       |
| Nonaccrual loans   | \$ 392                | 7                | 230               | 72                   | 17                    |
| Other nonperforming assets (primarily other real estate owned) |                       |                  |                   |                      |                       |
| Accruing loans 90 days or more past due                        | 55                    |                  |                   |                      |                       |
| Total nonperforming assets                                     | \$ 447                | 7                | 230               | 72                   | 17                    |
| as a % of loans  | 0.14%                 | 0.00             | 0.08              | 0.03                 | 0.01                  |

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**Table 8 - CDs and Other Time Deposits of \$100,000 or More**

| <i>(Dollars in thousands)</i>                              | <b>September 30,<br/>2007</b> |
|--|-------------------------------|
| <b>Maturity of:</b>  |                               |
| 3 months or less   | \$ 46,004                     |
| Over 3 months through 6 months                             | 11,186                        |
| Over 6 months through 12 months                            | 20,130                        |
| Over 12 months   | 77,911                        |
| <br>Total CDs and other time deposits of \$100,000 or more | <br>\$ 155,231                |

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

The Company models economic value of equity as a measure of market risk. As of December 2006, economic value of equity would increase 7.63% if rates decrease 200 basis points and decrease 27.14% if rates increase 200 basis points. As of September 2007, if rates decrease 200 basis points, economic value of equity would increase 5.96% and, if rates increase 200 basis points, economic value of equity would decrease 32.13%.

The Company is liability-sensitive for a 12 month forecast. The Company measures its exposure to interest risk by modeling a 200 (+ and -) basis point ramp in interest rates. Given these conditions, the Company's modeling projects that net interest income could decrease by 4.09% given a ramp up in interest rates of 200 basis points. For a ramp down in interest rates of 200 basis points, the modeling projects the Company's net interest income could increase by 2.19%. In December, the exposure in a ramp down scenario was a positive 5.74% and the ramp up exposure was a negative 5.61%. The Company recognizes there is uncertainty concerning the direction of future interest rates, therefore management has strived to reduce short-term earnings volatility. The model demonstrates the company is positioned for falling interest rates; however, the duration of assets and liabilities are fluid and driven by market conditions. As the Company does not consider this change in market sensitivity to be significant, the market rate table, as shown in the Company's annual report on Form 10-K for the year ended December 31, 2006, has not been updated in this filing.

**ITEM 4. CONTROLS AND PROCEDURES**

As of September 30, 2007, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Principal Financial and Accounting Officer, of the effectiveness of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the Chief Executive Officer and Principal Financial and Accounting Officer, concluded that the Company's disclosure controls and procedures were effective, in all material respects, to provide reasonable assurance that information required to be disclosed in the Company's reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations, and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and the Principal Financial and Accounting Officer, as appropriate, to allow timely decisions regarding disclosure.

During the period covered by this report, there has not been any change in the Company's internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal controls 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, 2006.

**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, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not 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.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**  
**ISSUER PURCHASES OF EQUITY SECURITIES<sup>(1)</sup>**

| Period                     | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Unit) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|----------------------------|---|--|---|---|
|                            | (Dollars in thousands except share data)    |  |   |   |
| July 1 - July 31           | 11,000                                      | \$ 25.76                               | N/A   | N/A   |
| August 1 - August 31       | 25,000                                      | \$ 25.32                               | N/A   | N/A   |
| September 1 - September 30 | -0-   | -0-                                    | N/A   | N/A   |
| Total                      | 36,000                                      | \$ 25.45                               | N/A   | N/A   |

<sup>(1)</sup> A total of 1,000 shares were purchased in privately negotiated transactions.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

**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                       | Bylaws of Auburn National Bancorporation, Inc. **   |
| 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, Assistant Vice President, Controller (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, Assistant Vice President, Controller (Principal Financial and Accounting Officer).***                             |

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

\*\* Incorporated by reference from Registrant's Form 8-K dated April 13, 2005.

\*\*\* The certifications attached as exhibits 32.1 and 32.2 accompany this Quarterly Report on Form 10-Q and 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

In accordance with 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: November 14, 2007

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

Date: November 14, 2007

By: /s/ David A. Hedges  
David A. Hedges  
Assistant Vice President, Controller  
(Principal Financial and Accounting Officer)