

SUCCESS & SERVICE IN CHALLENGING TIMES

AUBURN NATIONAL BANCORPORATION, INC.

2013 ANNUAL REPORT



SUCCESS
& SERVICE
IN CHALLENGING TIMES



AUBURN BANK

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TO OUR SHAREHOLDERS AND FRIENDS

The last few years have been trying for the banking industry as a whole. Recession, declining credit quality, a troubled housing market, reserve requirements, and modest loan demand have all been a challenge.

AuburnBank has been tested by these factors, but, through the efforts of our officers and staff, and with the support of our directors we have met the test and your bank is doing well.

We have always believed that credit issues and other problems needed prompt resolution and we have made some difficult decisions. As a result our reserves are strong, our loans are performing in a timely manner and we reported record earnings in 2013. This report details results that include earnings of \$1.95 per share compared to \$1.86 per share for the prior year.

We were founded in 1907 because the citizens of Auburn and this area needed their own, local bank. From that beginning we have been dedicating our time, our resources, and our skills to our local communities. We are here for our customers. We take care of your money and we are here to help when you need additional resources.

Thanks for allowing us to help you as an owner and as a customer of our bank. Remember, we are here for you.



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



FDIC

CORPORATE PROFILE

I am pleased to report that 2013 was a record earnings year for AuburnBank. Net income of \$7.1 million or \$1.95/per share was reported for the full year. This represents a 5% increase over net earnings for the year 2012. In addition to record earnings for the year, the Bank also continued to improve its credit quality, increase capital, reduce non-core funding, control our non-interest expense, and increase our annual dividend to shareholders. By reducing our higher cost borrowings by approximately \$35 million in 2013, we improved our net interest income and positively improved the overall funding mix.

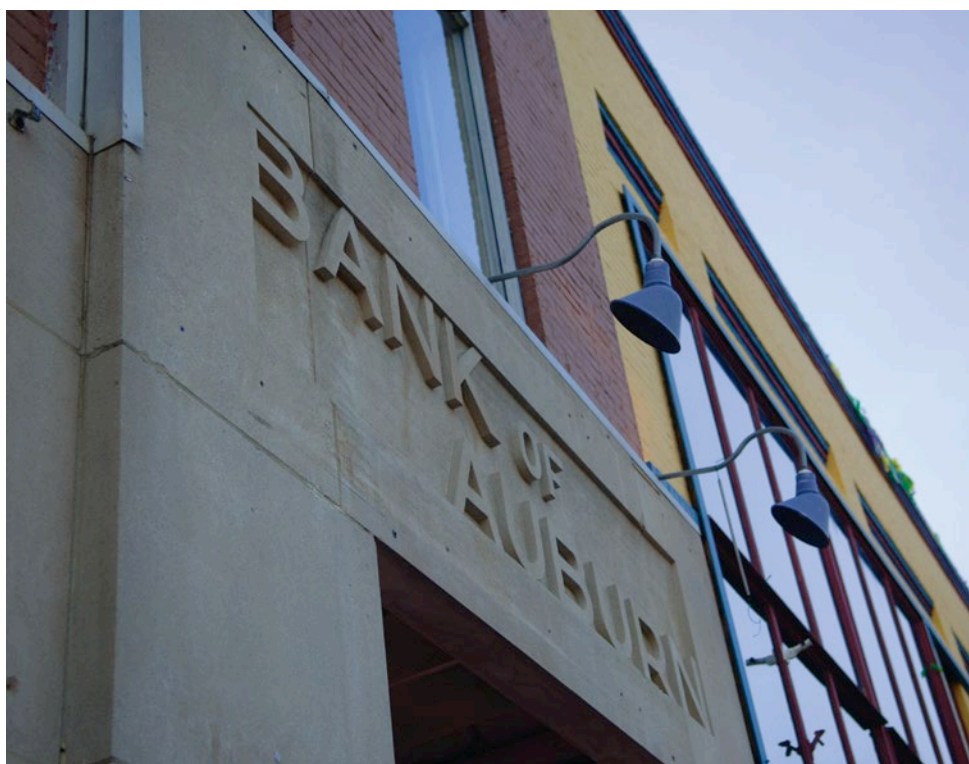
On behalf of the entire AuburnBank family, I would like to thank our customers and our shareholders for making 2013 a special year.

In the regulatory environment that we operate in, I would like to congratulate and commend our officers and staff on their commitment to providing top quality customer service and for their active involvement in many worthy community service organizations.

As we move into our 107th year of operation, we look forward to providing the financial products and services that all of our customers need and desire. We extend our deepest gratitude for your support and for your business and we look forward to continuing to be your partner, neighbor and friend in 2014.



Robert W. Dumas
President and CEO
AuburnBank



SUCCESS & SERVICE

IN CHALLENGING TIMES

In order to understand AuburnBank's success during the past five years of challenging economic times, it is important to look back at the very beginning of Auburn's only remaining chartered financial institution.



When Shel Toomer and a few supporters started The Bank of Auburn, they believed in several founding principles. The bank was organized to serve its citizens, the community and the college. From the very beginning, AuburnBank was focused on providing a safe place for customers to keep their money. In return, the bank would help the community by making loans to individuals, businesses, the city, and the

The image shows the exterior of an Auburn Bank building. The building is constructed of light-colored stone or brick. On the right side, there is a large blue logo of a bird in flight, enclosed in a rounded square. Below the logo, the words "AUBURN BANK" are written in a large, blue, serif font. On the left side of the image, there is a parking lot with several cars and a stop sign. The sky is clear and blue.

TOP 200 COMMUNITY BANK IN THE NATION

FOR SEVEN OF LAST EIGHT YEARS

{ according to American Banker
magazine based on average return
on equity for a three year period. }

RECORD NET EARNINGS OVER \$7 MILLION

I N 2 0 1 3

college, in order to allow local businesses to grow and expand and to assist individuals with their financial needs.

If we fast forward to the time-frame of 2009 – 2013, 102 years from the beginning of AuburnBank, the same principles that the original founders believed in are still guiding the leading financial institution in East Alabama. Because AuburnBank is still a community bank—a bank that cares—and because the bank believes in providing all customers with top quality service, the bank has continued to prosper even during tough economic times. Since 2009, AuburnBank has continued to meet the financial needs and desires of its customers in the communities it serves. In addition, for the past five years, AuburnBank has been able to increase

its overall earnings, earnings per share, capital, dividends and maintain its asset quality. These are pretty good results when property values were falling and not many businesses were expanding. The desire to understand customer needs and then provide sound prudent solutions to those needs are skills required in order to help customers succeed. Yes, 2013 was a record earnings year for AuburnBank, but the results would not have been possible without the vision of our founders and the leadership and management of its current Board of Directors and the entire AuburnBank team.

On behalf of the AuburnBank family, thank you to our shareholders and customers for believing and trusting in a bank that has a conscience to do what is right for its customers and its community.

EIGHTEEN
OUT OF THE LAST
NINETEEN
YEARS

DIVIDENDS
TO SHAREHOLDERS
HAVE INCREASED
*{They never declined}
{during the recession.}*

OVER \$745
MILLION
in Home Loans

FROM 2009 TO 2013

#1 IN MORTGAGE ORIGINATION
MARKET SHARE IN LEE COUNTY

Source: SNL Financial. Data originally
sourced to the Home Mortgage Disclosure
Act data compiled annually by the FFIEC.
Most recent market share data from 2012.

30%
MARKET
SHARE

FOR DEPOSITS
(OVER \$600 MILLION)

#1 OF 17 BANKS
IN LEE COUNTY

Source: FDIC Summary of Deposits.
Data as of June 30, 2013.

INCREASES
IN EARNINGS
PER SHARE
FOR FIVE
CONSECUTIVE
YEARS
SINCE 2009



AUBURN BANK

A TIME OF GROWTH

Opened Bent Creek
Branch in Auburn.



New branch in
Valley, Alabama
opens.

New Super Six Drive-Thru
opens at main branch.



2009

2010

2011

2012

COMMUNITY SERVICE

Active involvement in community projects and charitable and civic organizations has always been a part of AuburnBank's core values. The bank continues to support numerous worthy causes along with many individuals of the AuburnBank family who also contribute to many worthwhile community organizations and projects.

Just like our record-breaking earnings in 2013, our employees also set a new record in our giving to the Lee County United Way. This is just one of the many ways that our organization gives back to support the communities that we serve. Take a look around our community and you will find the AuburnBank team volunteering and extending a helping hand to make a difference in our friends' and neighbors' well-being.



Sara Beth Carrington (left) and Mellissa Stevens (right) donate during a recent blood drive.



Main Office campus improvements.



David Warren and Leigh Ann Thompson were an integral part of AuburnBank's United Way drive.

2013

AUBURN NATIONAL BANCORPORATION, INC. AND AUBURNBANK BOARD OF DIRECTORS



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

Terry W. Andrus
President, East Alabama
Medical Center

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

J. Tutt Barrett
Attorney, Dean and Barrett

Robert W. Dumas
President & CEO, AuburnBank

J.E. Evans
Owner, Evans Realty

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

David E. Housel
Director of Athletics Emeritus,
Auburn University

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

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

Edward Lee Spencer, III
Investor

AUBURNBANK OFFICERS

E.L. Spencer, Jr.
Chairman

Robert W. Dumas
President & Chief
Executive Officer

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

Vernon C. Bice, Jr.
Senior Vice President
Residential Real Estate

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

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

W. Thomas Johnson
Senior Vice President,
Senior Lender

Marla Kickliter
Senior Vice President,
Compliance/Internal Audit

Shannon O'Donnell
Senior Vice President,
Credit Administration

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

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

Bob R. Adkins
Vice President,
Commercial/Consumer Loans

Patty Allen
Vice President,
Commercial/Consumer Loans

Scottie Arnold
Vice President,
Retail Internet/
Operations Officer

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

S. Mark Bridges
Vice President,
Commercial/Consumer Loans

Laura Carrington
Vice President,
Human Resource Officer

Kathy Crawford
Vice President,
Commercial/Consumer Loans

Bruce Emfinger
Vice President,
Commercial/Consumer Loans

David Hedges
Vice President, Controller
and CFO

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

Susan K. McChesney
Vice President, IT/IS
Assistant Chief
Technology Officer

James R. Pack
Vice President,
Financial Reporting

Cyndee Redmond
Vice President, Operational
Coordinator for Electronic
Products and Services

John P. Ronan
Vice President,
Commercial/Consumer Loans

Robert Smith
Vice President,
Commercial/Consumer Loans

David Warren
Vice President,
Commercial/Consumer Loans

Barbara Wilcox
Vice President, Security and
Bank Secrecy Act Officer

Suzanne Gibson
Assistant Vice President,
Portfolio Management Officer

Charlotte Lang
Assistant Bank Secrecy Act Officer
and Operations Officer

Woody Odom
Assistant Vice President, IT/IS

Marcia Otwell
Shareholder Relations and
Administrative Officer

Jeff Stewart
Assistant Vice President,
Consumer Loan Officer

Christy A. Fogle
Assistant Vice President,
Loan Review Officer

Sam S. Rainer
Marketing Officer

OPELIKA BRANCH ADVISORY BOARD



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

William H. Brown
President, Brown Agency, Inc.

William G. Dyas
Businessman

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

William P. Johnston
President, J & M Bookstore

C. Eddie Smith
President,
AuburnBank of Opelika

R. Kraig Smith, M.D.
Lee OBGYN

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

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

VALLEY BRANCH ADVISORY BOARD



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

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

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

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

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

Roy W. McClendon, Jr.
Retired Pharmacist

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

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

FINANCIAL HIGHLIGHTS

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

	For the Years Ended December 31,				
	2013	2012	2011	2010	2009
Earnings					
Net Interest Income	\$20,922	\$20,897	\$19,225	\$18,899	\$18,815
Provision for Loan Losses	400	3,815	2,450	3,580	5,250
Net Earnings	7,118	6,763	5,538	5,346	2,404
Per Share:					
Net Earnings	1.95	1.86	1.52	1.47	0.66
Cash Dividends	0.84	0.82	0.80	0.78	0.76
Book Value	17.70	19.26	17.96	15.47	15.42
Shares Issued	3,957,135	3,957,135	3,957,135	3,957,135	3,957,135
Weighted Average Shares Outstanding	3,643,003	3,642,831	3,642,735	3,642,851	3,644,691
Financial Condition					
Total Assets	751,343	759,833	776,218	763,829	\$773,382
Loans, net of unearned income	383,339	398,193	370,263	374,215	376,103
Investment Securities	271,219	259,475	299,582	315,220	334,762
Total Deposits	668,844	636,817	619,552	607,127	579,409
Long Term Debt	12,217	47,217	85,313	93,331	118,349
Stockholders' Equity	64,485	70,149	65,416	56,368	56,183
Selected Ratios					
Return on Average Total Assets	0.94%	0.90%	0.72%	0.68%	0.31%
Return on Average Total Equity	10.33%	9.85%	9.10%	9.00%	4.23%
Average Stockholders' Equity to Average Assets	9.07%	9.09%	7.89%	7.61%	7.21%
Allowance for Loan Losses as a % of Loans	1.37%	1.69%	1.87%	2.05%	1.73%
Loans to Total Deposits	57.31%	62.53%	59.76%	61.64%	64.91%



AUBURN BANK

SINCE 1907
 YOUR PARTNER, YOUR NEIGHBOR,
 YOUR FRIEND

Financial Section

Auburn National Bancorporation, Inc. 2013 Annual Report

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SPECIAL CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

All written or oral forward-looking statements that are made by us or are attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made. A more detailed description of these and other risks is contained in the Company’s 2013 Annual Report on Form 10-K and in any of our subsequent reports that we make with the Securities and Exchange Commission (the “Commission” or “SEC”) under the Exchange Act.

BUSINESS INFORMATION

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

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

Services

The Bank offers checking, savings, transaction deposit accounts and certificates of deposit, and is an active residential mortgage lender in its primary service area. The Bank’s primary service area includes the cities of Auburn and Opelika, Alabama and nearby surrounding areas in East Alabama, primarily in Lee County. The Bank also offers commercial, financial, agricultural, real estate construction and consumer loan products and other financial services. The Bank is one of the largest providers of automated teller services in East Alabama and operates ATM machines in 13 locations in its primary service area. The Bank offers Visa® Checkcards, which are debit cards with the Visa logo that work like checks but can be used anywhere Visa is accepted, including ATMs. The Bank’s Visa Checkcards can be used internationally through the Cirrus® network. The Bank offers online banking and bill payment services through its Internet website, www.auburnbank.com.

Loans and Loan Concentrations

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

The Bank has loans outstanding to borrowers in all industries within its primary service area. Any adverse economic or other conditions affecting these industries would also likely have an adverse effect on the local workforce, other local businesses, and individuals in the community that have entered into loans with the Bank. The auto manufacturing business and its suppliers have positively affected our local economy, but automobile manufacturing is cyclical and adversely affected by increases in interest rates. Decreases in automobile sales, including adverse changes due to interest rate increases, could adversely affect the Kia and Hyundai plants and their suppliers' local spending and employment, and could adversely affect economic conditions in the markets we serve. However, management believes that due to the diversified mix of industries located within the Bank’s primary service area, adverse changes in one industry may not necessarily affect other area industries to the same degree or within the same time frame. The Bank’s primary service area also is subject to both local and national economic conditions and fluctuations. While most loans are made within our primary service area, some residential mortgage loans are originated outside the primary service area, and the Bank from time to time has purchased loan participations from outside its primary service area.

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

The following is a discussion of our financial condition at December 31, 2013 and 2012 and our results of operations for the years ended December 31, 2013, 2012, and 2011. The purpose of this discussion is to provide information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein. In addition, this discussion and analysis contains forward-looking statements, so you should refer to Item 1A, "Risk Factors" and "Special Cautionary Notice Regarding Forward-Looking Statements".

OVERVIEW

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

Summary of Results of Operations

	Year ended December 31		
<i>(Dollars in thousands, except per share data)</i>	2013	2012	2011
Net interest income (a)	\$ 22,362	\$ 22,539	\$ 20,944
Less: tax-equivalent adjustment	1,440	1,642	1,719
Net interest income (GAAP)	20,922	20,897	19,225
Noninterest income	7,298	10,483	5,177
Total revenue	28,220	31,380	24,402
Provision for loan losses	400	3,815	2,450
Noninterest expense	18,412	19,383	16,357
Income tax expense	2,290	1,419	57
Net earnings	\$ 7,118	\$ 6,763	\$ 5,538
Basic and diluted earnings per share	\$ 1.95	\$ 1.86	\$ 1.52

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

Financial Summary

The Company's net earnings were \$7.1 million, or \$1.95 per share, for the full year 2013, compared to \$6.8 million, or \$1.86 per share, for the full year 2012.

Net interest income (tax-equivalent) was \$22.4 million for the full year 2013, compared to \$22.5 million for the full year 2012. Although net interest income (tax-equivalent) declined slightly, continued improvement in the Company's funding mix and cost of funds largely offset declining yields on earning assets.

The provision for loan losses was \$0.4 million for the full year 2013, compared to \$3.8 million for the full year 2012. The decrease in the provision for loan losses was primarily due to a decline in net charge-offs and improvement in the overall credit quality of the loan portfolio, including lower levels of adversely classified and nonperforming loans. Net charge-offs were \$1.9 million, or 0.48% of average loans, for the full year 2013, compared to \$4.0 million, or 1.03% of average loans, for the full year 2012. This decrease was primarily due to a decline in net charge-offs for commercial real estate loans. In 2012, net charge-offs were impacted by a few individually significant charge-offs, including \$3.1 million related to three borrowing relationships.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Noninterest income was \$7.3 million in 2013, compared to \$10.5 million in 2012. The decrease was primarily due to a non-recurring gain of \$3.3 million realized in 2012 when the Company sold its interests in three affordable housing limited partnerships and a decrease in mortgage lending income of \$0.6 million as rising rates negatively impacted refinance activity. These decreases were partially offset by a \$1.0 million gain on sale of premises and equipment realized in 2013 when the Company sold certain real property in downtown Auburn that was no longer used for Company operations and was fully leased to third party tenants.

Noninterest expense was \$18.4 million in 2013, compared to \$19.4 million in 2012. The decrease was primarily due to a decrease in prepayment penalties on long-term debt of \$0.7 million. During 2013, the Company repaid \$35.0 million long-term debt with a weighted average interest rate of 3.46% and incurred prepayment penalties of \$3.0 million. During 2012, the Company repaid \$38.0 million of long-term debt with a weighted average interest rate of 4.26% and incurred prepayment penalties of \$3.7 million.

Income tax expense for the full year 2013 was \$2.3 million, compared to \$1.4 million for the full year 2012. The Company's effective income tax rate was 24.34% for the full year 2013, compared to 17.34% for the full year 2012. In addition to a 15% increase in the level of earnings before taxes, the Company's effective tax rate increased because the Company's annualized effective tax rate for 2012 was reduced by the reversal of a \$0.5 million deferred tax valuation allowance related to capital loss carry-forwards.

In 2013, the Company paid cash dividends of \$3.1 million, or \$0.84 per share. The Company remains well capitalized under current regulatory guidelines with a total risk-based capital ratio of 18.40%, a tier one risk-based capital ratio of 17.19%, and a tier one leverage capital ratio of 10.10% at December 31, 2013.

CRITICAL ACCOUNTING POLICIES

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

Allowance for Loan Losses

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

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

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan's effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

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

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

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

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2013 and 2012, and for the years then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

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

The Company regularly re-evaluates its practices in determining the allowance for loan losses. During 2013, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 quarter historical period. Beginning with the quarter ended June 30, 2013, the Company calculated average losses for all loan segments (except for the commercial real estate loan segment) using a rolling 8 quarter historical period in order to better capture the effects of the current economic cycle on the Company's loan loss experience and continued this methodology through December 31, 2013. Based upon management's review of charge-off trends for each loan segment, the Company continues to calculate average losses for the commercial real estate loan segment using a rolling 6 quarter historical period. Other than the changes discussed above, the Company has not made any changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

Assessment for Other-Than-Temporary Impairment of Securities

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

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

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

Fair Value Determination

U.S. GAAP requires management to value and disclose certain of the Company's assets and liabilities at fair value, including investments classified as available-for-sale and derivatives. ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 17, Fair Value, of the consolidated financial statements that accompany this report.

Fair values are based on active market prices of identical assets or liabilities when available. Comparable assets or liabilities or a composite of comparable assets in active markets are used when identical assets or liabilities do not have readily available active market pricing. However, some of the Company's assets or liabilities may lack an available or comparable trading market characterized by frequent transactions between willing buyers and sellers. In these cases, fair value is estimated using pricing models that use discounted cash flows and other pricing techniques. Pricing models and their underlying assumptions are based upon management's best estimates for appropriate discount rates, default rates, prepayments, market volatility and other factors, taking into account current observable market data and experience.

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

Other Real Estate Owned

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

Deferred Tax Asset Valuation

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of taxable income over the last three years and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at December 31, 2013. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

Average Balance Sheet and Interest Rates

	Year ended December 31					
	2013		2012		2011	
	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
<i>(Dollars in thousands)</i>						
Loans and loans held for sale	\$ 390,288	5.28%	\$ 395,938	5.54%	\$ 376,000	5.67%
Securities - taxable	195,850	2.00%	199,794	1.94%	223,638	2.69%
Securities - tax-exempt (a)	67,797	6.25%	77,447	6.24%	79,329	6.37%
Total securities	263,647	3.09%	277,241	3.14%	302,967	3.65%
Federal funds sold	48,671	0.22%	27,466	0.20%	28,905	0.19%
Interest bearing bank deposits	5,634	0.75%	793	—	1,394	0.05%
Total interest-earning assets	708,240	4.08%	701,438	4.38%	709,266	4.57%
Deposits:						
NOW	101,034	0.32%	99,664	0.35%	90,565	0.58%
Savings and money market	171,413	0.52%	153,668	0.56%	138,428	0.72%
Certificates of deposits less than \$100,000	105,631	1.36%	108,726	1.63%	114,490	1.95%
Certificates of deposits and other time deposits of \$100,000 or more	155,781	1.77%	161,128	2.08%	181,242	2.38%
Total interest-bearing deposits	533,859	1.01%	523,186	1.21%	524,725	1.54%
Short-term borrowings	2,817	0.50%	2,970	0.54%	2,423	0.50%
Long-term debt	31,518	3.59%	49,115	3.73%	86,899	3.91%
Total interest-bearing liabilities	568,194	1.15%	575,271	1.42%	614,047	1.87%
Net interest income and margin (a)	\$ 22,362	3.16%	\$ 22,539	3.21%	\$ 20,944	2.95%

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

RESULTS OF OPERATIONS

Net Interest Income and Margin

2013 vs. 2012 comparison

Net interest income (tax-equivalent) was \$22.4 million in 2013, compared to \$22.5 million in 2012. Although net interest income (tax-equivalent) declined slightly, management continues to seek to increase earnings by growing the Company's loan portfolio (in total and as a percentage of earning assets), focusing on deposit pricing, and repaying higher-cost wholesale funding sources. These efforts to increase earnings were offset by management's decision to reduce the Company's securities portfolio as a percentage of total interest earning assets and carry higher levels of short-term interest earning assets (e.g. federal funds sold) during 2013. As a result, the Company's net interest margin (tax-equivalent) declined to 3.16% in 2013, compared to 3.21% in 2012.

The tax-equivalent yield on total interest-earning assets decreased by 30 basis points in 2013 from 2012 to 4.08%. The decrease was primarily due to the shift in our asset mix described above and increased pricing competition for quality loan opportunities in our markets, which has limited the Company's ability to increase loans, generally, and to increase the yields on new and renewed loans, over the last several quarters.

The cost of total interest-bearing liabilities decreased 27 basis points in 2013 from 2012 to 1.15%. The net decrease was largely the result of the continued shift in our deposit mix, as we increased our lower-cost noninterest-bearing demand deposits, interest bearing demand deposits (NOW accounts), and savings and money market accounts and concurrently reduced balances of higher-cost certificates of deposit and other higher-cost time deposits and long-term debt (i.e. wholesale funding).

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

2012 vs. 2011 comparison

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

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

Provision for Loan Losses

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the probable losses on outstanding loans. The provision for loan losses amounted to \$0.4 million, \$3.8 million, and \$2.5 million for the years ended December 31, 2013, 2012, and 2011, respectively.

The provision for loan losses decreased in 2013 compared to 2012 primarily due to a decline in net charge-offs and improvement in the overall credit quality of the loan portfolio, including lower levels of adversely classified and nonperforming loans. Net charge-offs were \$1.9 million, or 0.48% of average loans, in 2013, compared to \$4.0 million, or 1.03% of average loans, in 2012. This decrease was primarily due to a decline in net charge-offs for commercial real estate loans. In 2012, net charge-offs were impacted by a few individually significant charge-offs, including \$3.1 million related to three borrowing relationships.

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

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes to be appropriate to adequately cover probable losses in the loan portfolio. The Company's allowance for loan losses to total loans decreased to 1.37% at December 31, 2013 from 1.69% at December 31, 2012. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2013. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are believed adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgment and are therefore approximate and imprecise. Factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions exist which may negatively and materially affect our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

Noninterest Income

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Service charges on deposit accounts	\$ 930	\$ 1,111	\$ 1,167
Mortgage lending	2,895	3,445	1,922
Bank-owned life insurance	427	445	460
Gain on sale of affordable housing investments	—	3,268	—
Affordable housing investment losses	—	—	(646)
Gain on sale of premises and equipment	1,018	—	—
Securities gains, net	651	679	878
Other	1,377	1,535	1,396
Total noninterest income	\$ 7,298	\$ 10,483	\$ 5,177

The Company's income from mortgage lending is primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing of mortgage loans. Origination income, net, is comprised of gains or losses from the sale of the mortgage loans originated, origination fees, underwriting fees and other fees associated with the origination of loans, which are netted against the commission expense associated with these originations. The Company's normal practice is to originate mortgage loans for sale in the secondary market and to either sell or retain the associated mortgage servicing rights ("MSRs") when the loan is sold.

MSRs are recognized based on the fair value of the servicing right on the date the corresponding mortgage loan is sold. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Servicing fee income is reported net of any related amortization expense.

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

The following table presents a breakdown of the Company's mortgage lending income for 2013, 2012, and 2011.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Origination income	\$ 2,030	\$ 3,430	\$ 1,680
Servicing fees, net	479	284	359
Decrease (increase) in MSR valuation allowance	386	(269)	(117)
Total mortgage lending income	\$ 2,895	\$ 3,445	\$ 1,922

2013 vs. 2012 comparison

The decrease in service charges on deposit accounts was primarily due to a decline in insufficient funds charges, reflecting changes in customer behavior and spending patterns.

The decrease in mortgage lending income was primarily due to a decline in origination income as refinance activity slowed. This decline was partially offset by a decrease in the valuation allowance for amortized MSRs and an increase in net servicing fees. Changes in the valuation allowance for amortized MSRs are recognized in earnings as a component of mortgage lending income. The decrease in the valuation allowance was primarily due to a slowing of prepayment speeds, which increased the value of our amortized MSRs.

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

In 2013, the Company recognized a \$1.0 million gain on sale of premises and equipment when the Company sold certain real property in downtown Auburn that was no longer used for Company operations and was fully leased to third party tenants.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Net securities gains consist of realized gains and losses on the sale of securities and other-than-temporary impairment charges. Net securities gains were \$0.7 million in both 2013 and 2012. Gross realized gains of \$0.8 million in 2013 were reduced by gross realized losses of \$0.1 million. Gross realized gains of \$1.0 million in 2012 were reduced by gross realized losses of \$0.2 million and \$0.1 million in other-than-temporary impairment charges related to trust preferred securities. In December 2013, the Company sold all remaining trust preferred securities held by the Company for a net loss of \$0.1 million.

2012 vs. 2011 comparison

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

Mortgage lending income was \$3.4 million in 2012, compared to \$1.9 million in 2011. A increase in the level of mortgage refinance activity during 2012 when compared to the levels experienced during 2011 contributed to the increase in mortgage lending income. The Company's income from mortgage lending typically fluctuates as mortgage interest rates change and is primarily attributable to origination and sale of new mortgage loans.

The Company recognized a gain on sale of \$3.3 million related to the sale of its interests in three affordable housing limited partnerships in January 2012. Accordingly, the Company did not receive any federal tax credits related to affordable housing partnership investments in 2012. Prior to the sale of these interests, the Company accrued its pro-rata share of partnership losses in noninterest income. In 2011, the Company accrued approximately \$0.6 million related to affordable housing investment losses.

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

Noninterest Expense

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Salaries and benefits	\$ 8,788	\$ 8,691	\$ 8,167
Net occupancy and equipment	1,335	1,332	1,404
Professional fees	774	704	735
FDIC and other regulatory assessments	512	686	792
Other real estate owned, net	570	323	2,007
Prepayment penalties on long-term debt	3,028	3,720	—
Other	3,405	3,927	3,252
Total noninterest expense	\$ 18,412	\$ 19,383	\$ 16,357

2013 vs. 2012 comparison

Salaries and benefits expense increased primarily due to routine increases in salaries and wages. This increase was largely offset by a decrease in group health insurance costs. Beginning in 2013, the Company returned to a fully insured group health plan and was able to lower its benefits costs compared to 2012. Previously, the Company's group health plan was self insured.

The decrease in FDIC and other regulatory assessments expense was primarily due to a decrease in the Bank's quarterly assessment rate as several variables utilized by the FDIC in calculating our deposit insurance assessments improved.

Other real estate owned expense, net was \$0.6 million in 2013, compared to \$0.3 million in 2012. The increase was primarily due to realized holding losses or write-downs on the valuations of certain OREO properties. These properties could also be subject to future valuation adjustments as a result of updated appraisal information and further deterioration in real estate values, thus causing additional fluctuations in other real estate owned expense, net. Also, the Company will continue to incur expenses associated with maintenance costs and property taxes associated with these assets.

During 2013, the Company repaid \$35.0 million long-term debt with a weighted average interest rate of 3.46% and incurred prepayment penalties of \$3.0 million. During 2012, the Company repaid \$38.0 million of long-term debt with a weighted average interest rate of 4.26% and incurred prepayment penalties of \$3.7 million.

2012 vs. 2011 comparison

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

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

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

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

Income Tax Expense

2013 vs. 2012 comparison

Income tax expense for 2013 was \$2.3 million, compared to \$1.4 million in 2012. The Company's effective income tax rate was 24.34% in 2013, compared to 17.34% in 2012. In addition to a 15% increase in the level of earnings before taxes, the Company's effective tax rate increased because the Company's annualized effective tax rate for 2012 was reduced by the reversal of a \$0.5 million deferred tax valuation allowance related to capital loss carry-forwards.

2012 vs. 2011 comparison

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

BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale, were \$271.2 million at December 31, 2013, an increase of \$11.8 million, or 4%, compared to \$259.5 million as of December 31, 2012. This increase reflects an increase in the amortized cost basis of securities available-for-sale of \$27.1 million, which was partially offset by a decline in the fair value of securities-available-for-sale of \$15.4 million. The increase in the amortized cost basis of securities available-for-sale was primarily attributable to management allocating more funding to the investment portfolio as the loan portfolio declined and investment yields improved in 2013. The decrease in the fair value of securities was primarily due to an increase in long-term interest rates. The average tax-equivalent yields earned on total securities were 3.09% in 2013 and 3.14% in 2012.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2013 according to contractual maturity. Actual maturities may differ from contractual maturities of residential mortgage-backed securities ("RMBS") because the mortgages underlying the securities may be called or prepaid with or without penalty.

<i>(Dollars in thousands)</i>	December 31, 2013				
	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Total Fair Value
Agency obligations	\$ —	—	23,247	21,275	44,522
Agency RMBS	—	—	8,306	154,052	162,358
State and political subdivisions	—	1,735	21,366	41,238	64,339
Total available-for-sale	\$ —	1,735	52,919	216,565	271,219
Weighted average yield:					
Agency obligations	—	—	2.06%	2.79%	2.34%
Agency RMBS	—	—	1.74%	2.35%	2.32%
State and political subdivisions	—	4.14%	4.05%	4.12%	4.10%
Total available-for-sale	—	4.14%	2.81%	2.70%	2.74%

Loans

<i>(In thousands)</i>	December 31				
	2013	2012	2011	2010	2009
Commercial and industrial	\$ 57,780	59,334	54,988	53,288	53,884
Construction and land development	36,479	37,631	39,814	47,850	56,820
Commercial real estate	174,920	183,611	162,435	166,241	156,928
Residential real estate	101,706	105,631	101,725	96,241	97,407
Consumer installment	12,893	12,219	11,454	10,676	11,236
Total loans	383,778	398,426	370,416	374,296	376,275
Less: unearned income	(439)	(233)	(153)	(81)	(172)
Loans, net of unearned income	\$ 383,339	398,193	370,263	374,215	376,103

Total loans, net of unearned income, were \$383.3 million at December 31, 2013, a decrease of \$14.9 million, or 4%, from \$398.2 million at December 31, 2012. The decrease was primarily attributable to reduced loan demand and increased competition for quality loan opportunities in our markets and management's efforts to resolve problem loans as nonaccrual loans declined by \$6.3 million in 2013. Four loan categories represented the majority of the loan portfolio as December 31, 2013: commercial real estate mortgage loans (46%), residential real estate mortgage loans (27%), commercial and industrial loans (15%) and construction and land development loans (10%).

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately \$15.8 million, or 4%, of total loans, net of unearned income at both December 31, 2013 and 2012. For residential real estate mortgage loans with a consumer purpose, approximately \$1.2 million and \$1.3 million required interest-only payments at December 31, 2013 and 2012, respectively. The Company's residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high-risk consumer mortgage products.

Purchased loan participations included in the Company's loan portfolio were approximately \$1.4 million and \$3.1 million as of December 31, 2013 and 2012, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company's normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures as described in "CRITICAL ACCOUNTING POLICIES."

The average yield earned on loans and loans held for sale was 5.28% in 2013 and 5.54% in 2012.

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

The Company attempts to reduce these economic and credit risks by adhering to loan to value guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers' financial position. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit a bank's credit exposure by prohibiting unsecured loan relationships that exceed 10% of its capital accounts; or 20% of capital accounts, if loans in excess of 10% are fully secured. Under these regulations, we are prohibited from having unsecured loan relationships in excess of approximately \$16.0 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$14.4 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At December 31, 2013, the Bank had no loan relationships exceeding these limits.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any one or more industries. We use classification systems broadly accepted by the financial services industry in order to categorize our commercial borrowers. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank's total risk-based capital at December 31, 2013 (and related balances at December 31, 2012).

<i>(In thousands)</i>	December 31	
	2013	2012
Lessors of 1-4 family residential properties	\$ 43,835	\$ 47,544
Multi-family residential properties	27,673	30,392
Shopping centers	29,953	20,760

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company's estimate of probable losses in the loan portfolio. As of December 31, 2013 and 2012, respectively, the allowance for loan losses was \$5.3 million and \$6.7 million, respectively, which management believed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under "CRITICAL ACCOUNTING POLICIES".

MANAGEMENT'S DISCUSSION AND ANALYSIS

A summary of the changes in the allowance for loan losses and certain asset quality ratios for each of the five years in the five year period ended December 31, 2013 is presented below.

<i>(Dollars in thousands)</i>	Year ended December 31				
	2013	2012	2011	2010	2009
Allowance for loan losses:					
Balance at beginning of period	\$ 6,723	6,919	7,676	6,495	4,398
Charge-offs:					
Commercial and industrial	(514)	(289)	(679)	(537)	(495)
Construction and land development	(39)	(231)	(1,758)	(1,487)	(2,088)
Commercial real estate	(262)	(3,184)	(422)	—	—
Residential real estate	(808)	(545)	(533)	(552)	(704)
Consumer installment	(397)	(85)	(21)	(111)	(61)
Total charge-offs	(2,020)	(4,334)	(3,413)	(2,687)	(3,348)
Recoveries:					
Commercial and industrial	48	54	34	63	47
Construction and land development	6	46	2	54	50
Commercial real estate	4	71	—	—	—
Residential real estate	88	134	155	151	92
Consumer installment	19	18	15	20	6
Total recoveries	165	323	206	288	195
Net charge-offs	(1,855)	(4,011)	(3,207)	(2,399)	(3,153)
Provision for loan losses	400	3,815	2,450	3,580	5,250
Ending balance	\$ 5,268	6,723	6,919	7,676	6,495
as a % of loans	1.37 %	1.69	1.87	2.05	1.73
as a % of nonperforming loans	124 %	64	67	65	69
Net charge-offs as a % of average loans	0.48 %	1.03	0.86	0.64	0.84

As noted under "CRITICAL ACCOUNTING POLICIES", management assesses the adequacy of the allowance prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.37% at December 31, 2013, compared to 1.69% at December 31, 2012. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken.

Net charge-offs were \$1.9 million, or 0.48% of average loans, in 2013, compared to net charge-offs of \$4.0 million, or 1.03%, in 2012. In 2012, net charge-offs were affected by a few individually significant charge-offs in the commercial real estate portfolio segment, including \$3.1 million related to three borrowing relationships.

At December 31, 2013 and 2012, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 124% and 64%, respectively. The increase was primarily due to payoffs received on three nonperforming commercial loans real estate loans during 2013 with a total recorded investment of \$5.9 million and no related allowance for loan losses at December 31, 2012. Excluding these nonperforming loans, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 144% at December 31, 2012.

At December 31, 2013 and 2012, the Company's recorded investment in loans considered impaired was \$5.6 million and \$10.5 million, respectively, with corresponding valuation allowances (included in the allowance for loan losses) at each respective date of \$0.3 million.

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

Nonperforming Assets

At December 31, 2013 the Company had \$8.1 million in nonperforming assets compared to \$15.5 million at December 31, 2012. Nonperforming assets decreased during 2013 due to continued efforts by management to reduce and resolve problem assets. The majority of the balance in nonperforming assets at December 31, 2013 related to deterioration in the commercial real estate and construction and land development loan portfolios.

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

<i>(Dollars in thousands)</i>	December 31				
	2013	2012	2011	2010	2009
Nonperforming assets:					
Nonperforming (nonaccrual) loans	\$ 4,261	10,535	10,354	11,833	9,352
Other real estate owned	3,884	4,919	7,898	8,125	7,292
Total nonperforming assets	\$ 8,145	15,454	18,252	19,958	16,644
as a % of loans and foreclosed properties	2.10 %	3.83	4.83	5.22	4.34
as a % of total assets	1.08 %	2.03	2.35	2.61	2.15
Nonperforming loans as a % of total loans	1.11 %	2.65	2.80	3.16	2.49
Accruing loans 90 days or more past due	\$ 73	58	—	—	5

The table below provides information concerning the composition of nonaccrual loans at December 31, 2013 and 2012, respectively.

<i>(In thousands)</i>	December 31	
	2013	2012
Nonaccrual loans:		
Commercial and industrial	\$ 55	60
Construction and land development	1,582	1,706
Commercial real estate	1,456	6,714
Residential real estate	1,168	2,055
Total nonaccrual loans / nonperforming loans	\$ 4,261	10,535

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At December 31, 2013, the Company had \$4.3 million in loans on nonaccrual, compared to \$10.5 million at December 31, 2012. The decrease was primarily attributable to a decrease of \$5.3 million and \$0.9 million in nonaccrual loans for the commercial real estate and residential real estate loan portfolio segments, respectively.

Due to the weakening credit status of a borrower, the Company may elect to formally restructure certain loans to facilitate a repayment plan that minimizes the potential losses that we might incur. Restructured loans, or troubled debt restructurings (“TDRs”), are classified as impaired loans, and if the loans are on nonaccrual status as of the date of restructuring, the loans are included in the nonaccrual loan balances noted above. Nonaccrual loan balances do not include loans that have been restructured that were performing as of the restructure date. At December 31, 2013 and 2012, the Company had \$1.6 million and \$1.1 million, respectively, in accruing TDRs.

At December 31, 2013 there were \$73,000 in loans 90 days past due and still accruing interest compared to \$58,000 at December 31, 2012.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The table below provides information concerning the composition of OREO at December 31, 2013 and 2012, respectively.

<i>(In thousands)</i>	December 31	
	2013	2012
Other real estate owned:		
Commercial:		
Building	\$ 1,772	608
Developed lots	1,260	1,275
Residential:		
Condominiums	—	425
Undeveloped land	113	1,464
Other	739	1,147
Total other real estate owned	\$ 3,884	4,919

At December 31, 2013, the Company held \$3.8 million in OREO, which we acquired from borrowers, a decrease of \$1.0 million, or 21%, compared to December 31, 2012. At December 31, 2013, approximately \$3.2 million, or 82%, of the total balance in OREO related to properties acquired from three borrowers.

Potential Problem Loans

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Federal Reserve, the Company's primary regulator, for loans classified as substandard, excluding nonaccrual loans. Potential problem loans, which are not included in nonperforming assets, amounted to \$10.6 million, or 2.7% of total loans at December 31, 2013, compared to \$12.6 million, or 3.2% of total loans at December 31, 2012.

The table below provides information concerning the composition of potential problem loans at December 31, 2013 and 2012, respectively.

<i>(In thousands)</i>	December 31	
	2013	2012
Potential problem loans:		
Commercial and industrial	\$ 482	563
Construction and land development	1,101	1,125
Commercial real estate	1,683	2,727
Residential real estate	7,182	7,978
Consumer installment	146	214
Total potential problem loans	\$ 10,594	12,607

At December 31, 2013, approximately \$0.8 million or 7.6% of total potential problem loans were past due at least 30 but less than 90 days. At December 31, 2013, the remaining balance of potential problem loans were current or past due less than 30 days.

The following table is a summary of the Company's performing loans that were past due at least 30 days but less than 90 days as of December 31, 2013 and 2012, respectively.

<i>(In thousands)</i>	December 31	
	2013	2012
Performing loans past due 30 to 89 days:		
Commercial and industrial	\$ 167	173
Construction and land development	14	8
Commercial real estate	861	230
Residential real estate	1,343	1,537
Consumer installment	100	62
Total performing loans past due 30 to 89 days	\$ 2,485	2,010

Deposits

<i>(In thousands)</i>	December 31	
	2013	2012
Noninterest bearing demand	\$ 125,740	118,014
NOW	99,406	96,332
Money market	147,116	124,676
Savings	35,383	34,600
Certificates of deposit under \$100,0000	104,964	106,371
Certificates of deposit and other time deposits of \$100,000 or more	139,721	134,591
Brokered certificates of deposit	16,514	22,233
Total deposits	\$ 668,844	636,817

Total deposits were \$668.9 million and \$636.8 million at December 31, 2013 and 2012, respectively. The increase in total deposits of \$32.0 million reflects market share growth in Chambers County due to the business development efforts of the Bank's full-service branch in Valley, Alabama which opened in December 2011 and changes in customer preferences for short-term instruments in a low interest rate environment.

The average rates paid on total interest-bearing deposits were 1.01% in 2013 and 1.21% in 2012. Noninterest bearing deposits were 19% of total deposits at both December 31, 2013 and 2012.

Other Borrowings

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity of one year or less. The Bank had available federal fund lines totaling \$41.0 million with none outstanding at December 31, 2013, compared to \$40.0 million with none outstanding at and December 31, 2012. Securities sold under agreements to repurchase totaled \$3.4 million and \$2.7 million at December 31, 2013 and 2012, respectively.

The average rates paid on short-term borrowings were 0.50% in 2013 and 0.54% in 2012. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the three-year period ended December 31, 2013 is included in Note 10 to the accompanying consolidated financial statements included in this annual report.

Long-term debt includes FHLB advances with an original maturity greater than one year, securities sold under agreements to repurchase with an original maturity greater than one year, and subordinated debentures related to trust preferred securities. The Bank had \$5.0 million in long-term FHLB advances at December 31, 2013, compared to \$25.0 million at December 31, 2012. During 2013, the Company repaid \$20.0 million of FHLB advances with a weighted average interest rate of 3.38%. At December 31, 2013, the Bank had no securities sold under agreements to repurchase with an original maturity greater than one year, compared to \$15.0 million at December 31, 2012. During 2013, the Company repaid \$15.0 million of securities sold under agreements to repurchase with an interest rate of 3.58%. At both December 31, 2013 and 2012, the Company had \$7.2 million in junior subordinated debentures related to trust preferred securities outstanding.

The average rates paid on long-term debt were 3.59% in 2013 and 3.73% in 2012.

CAPITAL ADEQUACY

The Company's consolidated stockholders' equity was \$64.5 million and \$70.1 million as of December 31, 2013 and 2012, respectively. The change from December 31, 2012 was primarily driven by an other comprehensive loss due to the change in unrealized gains (losses) on securities available-for-sale of \$9.7 million and cash dividends paid of \$3.1 million, partially offset by net earnings of \$7.1 million.

The Company's tier 1 leverage ratio was 10.10%, tier 1 risk-based capital ratio was 17.19% and total risk-based capital ratio was 18.40% at December 31, 2013. These ratios exceed the minimum regulatory capital percentages of 4.0% for Tier 1 leverage ratio, 4.0% for Tier 1 risk-based capital ratio and 8.0% for Total risk-based capital ratio. Based on current regulatory standards, the Company is classified as "well capitalized."

MARKET AND LIQUIDITY RISK MANAGEMENT

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

Interest Rate Risk Management

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

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

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

To limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income to less than a 10 percent decline for a 200 basis point gradual change up or down in rates from management's baseline net interest income forecast over the next 12 months. The following table reports the variance of net interest income over the next 12 months assuming a gradual change in interest rates of 200 basis points when compared to the baseline net interest income forecast at December 31, 2013.

Changes in Interest Rates	Net Interest Income % Variance
200 basis points	1.35 %
(200) basis points	NM

NM=not meaningful

At December 31, 2013, our earnings simulation model indicated a slightly asset-sensitive position over the next 12 months, which could serve to improve net interest income during that time period if interest rates increased by 200 basis points. The actual realized change in net interest income would depend upon several factors, which could also serve to diminish, or eliminate the asset sensitivity noted above. The impact of rate scenarios assuming a gradual downward 200 basis point change in interest rates was not considered meaningful because of the historically low interest rate environment.

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

To help limit interest rate risk, we have a guideline stating that for a 200 basis point instantaneous change in interest rates up or down, EVE should not decrease by more than 25 percent. The following table reports the variance of EVE assuming an immediate change in interest rates of 200 basis points when compared to the base case EVE at December 31, 2013.

Changes in Interest Rates	EVE % Variance
200 basis points	(16.16) %
(200) basis points	NM

NM=not meaningful

At December 31, 2013, the results of our EVE model would indicate that we are in compliance with our guidelines. The actual realized change in the economic value of equity would depend upon several factors, which could also serve to diminish, or eliminate the interest sensitivity noted above. The impact of rate shock scenarios assuming a downward 200 basis point change in interest rates was not considered meaningful because of the historically low interest rate environment.

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

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

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps (“swaps”) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2013 and 2012, the Company had no derivative contracts to assist in managing interest rate sensitivity.

Liquidity Risk Management

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

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB's advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. As of December 31, 2013, the Bank had a remaining available line of credit with the FHLB totaling \$212.4 million. As of December 31, 2013, the Bank also had \$41.0 million of federal funds lines, with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

The following table presents additional information about our contractual obligations as of December 31, 2013, which by their terms had contractual maturity and termination dates subsequent to December 31, 2013:

<i>(Dollars in thousands)</i>	Total	Payments due by period			
		1 year or less	1 to 3 years	3 to 5 years	More than 5 years
Contractual obligations:					
Deposit maturities (1)	\$ 668,844	536,260	75,784	46,369	10,431
Long-term debt	12,217	—	—	5,000	7,217
Operating lease obligations	617	287	285	45	—
Total	\$ 681,678	\$536,547	\$76,069	\$51,414	\$17,648

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

Management believes that the Company and the Bank have adequate sources of liquidity to meet all known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next 12 months.

Off-Balance Sheet Arrangements

At December 31, 2013, the Bank had outstanding standby letters of credit of \$8.6 million and unfunded loan commitments outstanding of \$38.9 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase federal funds from other financial institutions.

Mortgage lending activities

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

As of December 31, 2013, the unpaid principal balance of the residential mortgage loans, which we have originated and sold, but retained the servicing rights was \$356.3 million. Although these loans are generally sold on a non-recourse basis, except for breaches of customary seller representations and warranties, we may have to repurchase residential mortgage loans in cases where we breach such representations or warranties or the other terms of the sale, such as where we fail to deliver required documents or the documents we deliver are defective. Investors also may require the repurchase of a mortgage loan when an early payment default underwriting review reveals significant underwriting deficiencies, even if the mortgage loan has subsequently been brought current. Repurchase demands are typically reviewed on an individual loan by loan basis to validate the claims made by the investor and to determine if a contractually required repurchase event has occurred. We seek to reduce and manage the risks of potential repurchases or other claims by mortgage loan investors

through our underwriting, quality assurance and servicing practices, including good communications with our residential mortgage investors.

We were not required to repurchase any residential mortgage loans in 2013 or 2011. In 2012, we repurchased one residential mortgage loan with an unpaid principal balance of \$0.3 million. This loan was current as to principal and interest at the time of repurchase, and we incurred no losses upon repurchase.

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

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

Although to date repurchase requests related to representation and warranty provisions, and servicing activities have been limited, it is possible that requests to repurchase mortgage loans may increase in frequency if investors more aggressively pursue all means of recovering losses on their purchased loans. As of December 31, 2013, we believe that this exposure is not material due to the historical level of repurchase requests and loss trends, in addition to the fact that 99.5% of our residential mortgage loans serviced for Fannie Mae were current as of such date. We maintain ongoing communications with our investors and will continue to evaluate this exposure by monitoring the level and number of repurchase requests as well as the delinquency rates in our investor portfolios.

Effects of Inflation and Changing Prices

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

CURRENT ACCOUNTING DEVELOPMENTS

The following Accounting Standards Updates ("Updates" or "ASUs") have been issued by the FASB but are not yet effective.

- ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*;
- ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*; and
- ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*.

Information about these pronouncements is described in more detail below.

ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*, is expected to eliminate diversity in practice as it provides guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward exists. These changes are effective for the Company in the first quarter of 2014 with prospective application applied to all unrecognized tax benefits that exist at the effective date. Early adoption and retrospective application are permitted. Adoption of this ASU will not have a significant impact on the financial statements of the Company.

ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*, amends the criteria a company must meet to elect to account for investments in qualified affordable housing projects using a method other than the cost or equity methods. If the criteria are met, a company is permitted to amortize the initial investment cost in proportion to and over the same period as the total tax benefits the company expects to receive. The amortization of the initial investment cost and tax benefits are to be recorded in the income tax expense line. The Update also requires new disclosures about all investments in qualified affordable housing projects regardless of the accounting method used. These changes are effective for the Company in the first quarter of 2015 with retrospective application. Early adoption is permitted. The Company is evaluating the impact this ASU will have on our consolidated financial statements.

ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*, clarifies the timing of when a creditor is considered to have taken physical possession of residential real estate collateral for a consumer mortgage loan, resulting in the reclassification of the loan receivable to real estate owned. A creditor has taken physical possession of the property when either (1) the creditor obtains legal title through foreclosure, or (2) the borrower transfers all interests in the property to the creditor via a deed in lieu of foreclosure or a similar legal agreement. The Update also requires disclosure of the amount of foreclosed residential real estate property held by the creditor and the recorded investment in residential real estate mortgage loans that are in process of foreclosure. These changes are effective for the Company in the first quarter of 2015 with retrospective application. Early adoption is permitted. Adoption of this ASU will not have a significant impact on the financial statements of the Company.

Table 1 – Explanation of Non-GAAP Financial Measures

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

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

	2013				2012			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
<i>(in thousands)</i>								
Net interest income (GAAP)	\$ 5,279	5,270	5,232	5,141	5,325	5,259	5,312	5,001
Tax-equivalent adjustment	342	351	365	382	396	416	416	414
Net interest income (Tax-equivalent)\$	5,621	5,621	5,597	5,523	5,721	5,675	5,728	5,415

	Year ended December 31				
	2013	2012	2011	2010	2009
<i>(In thousands)</i>					
Net interest income (GAAP)	\$ 20,922	20,897	19,225	18,899	18,815
Tax-equivalent adjustment	1,440	1,642	1,719	1,765	1,633
Net interest income (Tax-equivalent)	\$ 22,362	22,539	20,944	20,664	20,448

Table 2 - Selected Financial Data

<i>(Dollars in thousands, except per share amounts)</i>	Year ended December 31				
	2013	2012	2011	2010	2009
Income statement					
Tax-equivalent interest income (a)	\$ 28,898	30,709	32,425	35,237	38,467
Total interest expense	6,536	8,170	11,481	14,573	18,019
Tax equivalent net interest income (a)	22,362	22,539	20,944	20,664	20,448
Provision for loan losses	400	3,815	2,450	3,580	5,250
Total noninterest income	7,298	10,483	5,177	6,718	2,433
Total noninterest expense	18,412	19,383	16,357	15,893	13,934
Net earnings before income taxes and tax-equivalent adjustment	10,848	9,824	7,314	7,909	3,697
Tax-equivalent adjustment	1,440	1,642	1,719	1,765	1,633
Income tax expense (benefit)	2,290	1,419	57	798	(340)
Net earnings	\$ 7,118	6,763	5,538	5,346	2,404
Per share data:					
Basic and diluted net earnings	\$ 1.95	1.86	1.52	1.47	0.66
Cash dividends declared	\$ 0.84	0.82	0.80	0.78	0.76
Weighted average shares outstanding					
Basic and diluted	3,643,003	3,642,831	3,642,735	3,642,851	3,644,691
Shares outstanding	3,643,118	3,642,903	3,642,738	3,642,718	3,643,117
Book value	\$ 17.70	19.26	17.96	15.47	15.42
Common stock price					
High	\$ 25.75	26.65	20.37	22.00	30.00
Low	20.80	18.23	18.52	16.86	18.07
Period-end	\$ 25.00	20.85	18.52	20.06	19.69
To earnings ratio	12.89x	11.21	12.10	13.74	29.39
To book value	141 %	108	103	130	128
Performance ratios:					
Return on average equity	10.33 %	9.85	9.10	9.00	4.23
Return on average assets	0.94 %	0.90	0.72	0.68	0.31
Dividend payout ratio	43.08 %	44.09	52.63	53.06	115.15
Average equity to average assets	9.07 %	9.09	7.89	7.61	7.21
Asset Quality:					
Allowance for loan losses as a % of:					
Loans	1.37 %	1.69	1.87	2.05	1.73
Nonperforming loans	124 %	64	67	65	69
Nonperforming assets as a % of:					
Loans and foreclosed properties	2.10 %	3.83	4.83	5.22	4.34
Total assets	1.08 %	2.03	2.35	2.61	2.15
Nonperforming loans as % of loans	1.11 %	2.65	2.80	3.16	2.49
Net charge-offs as a % of average loans	0.48 %	1.03	0.86	0.64	0.84
Capital Adequacy:					
Tier 1 risk-based capital ratio	17.19 %	16.20	15.40	14.57	13.73
Total risk-based capital ratio	18.40 %	17.46	16.66	15.82	14.98
Tier 1 Leverage ratio	10.10 %	9.58	8.82	8.47	8.13
Other financial data:					
Net interest margin (a)	3.16 %	3.21	2.95	2.86	2.78
Effective income tax expense (benefit) rate	24.34 %	17.34	1.02	12.99	(16.47)
Efficiency ratio (b)	62.08 %	58.70	62.62	58.04	60.90
Selected period end balances:					
Securities	\$ 271,219	259,475	299,582	315,220	334,762
Loans, net of unearned income	383,339	398,193	370,263	374,215	376,103
Allowance for loan losses	5,268	6,723	6,919	7,676	6,495
Total assets	751,343	759,833	776,218	763,829	773,382
Total deposits	668,844	636,817	619,552	607,127	579,409
Long-term debt	12,217	47,217	85,313	93,331	118,349
Total stockholders' equity	64,485	70,149	65,416	56,368	56,183

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

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

Table 3 - Selected Quarterly Financial Data

<i>(Dollars in thousands, except per share amounts)</i>	2013				2012			
	Fourth	Third	Second	First	Fourth	Third	Second	First
Income statement								
Tax-equivalent interest income (a)	\$ 7,108	7,207	7,226	7,357	7,646	7,628	7,773	7,662
Total interest expense	1,487	1,586	1,629	1,834	1,925	1,953	2,045	2,247
Tax equivalent net interest income (a)	5,621	5,621	5,597	5,523	5,721	5,675	5,728	5,415
Provision for loan losses	—	—	—	400	1,065	1,550	600	600
Total noninterest income	2,140	1,432	2,071	1,655	1,788	2,017	1,814	4,864
Total noninterest expense	5,188	4,274	4,724	4,226	4,023	3,770	4,048	7,542
Net earnings before income taxes and tax-equivalent adjustment	2,573	2,779	2,944	2,552	2,421	2,372	2,894	2,137
Tax-equivalent adjustment	342	351	365	382	396	416	416	414
Income tax expense	501	636	672	481	365	347	449	258
Net earnings	\$ 1,730	1,792	1,907	1,689	1,660	1,609	2,029	1,465
Per share data:								
Basic and diluted net earnings	\$ 0.47	0.49	0.52	0.46	0.46	0.44	0.56	0.40
Cash dividends declared	\$ 0.21	0.21	0.21	0.21	0.205	0.205	0.205	0.205
Weighted average shares outstanding								
Basic and diluted	3,643,110	3,643,028	3,642,955	3,642,918	3,642,903	3,642,876	3,642,826	3,642,738
Shares outstanding, at period end	3,643,118	3,643,058	3,642,993	3,642,928	3,642,903	3,642,903	3,642,843	3,642,738
Book value	\$ 17.70	18.06	17.90	19.27	19.26	19.27	18.75	18.11
Common stock price								
High	\$ 25.75	24.71	22.33	22.60	24.87	23.20	26.65	21.99
Low	23.93	22.00	21.54	20.80	20.85	21.00	21.50	18.23
Period-end	\$ 25.00	24.40	22.00	22.00	20.85	22.25	21.50	21.99
To earnings ratio	12.89 x	12.64	11.70	11.46	11.21	12.94	12.95	14.66
To book value	141 %	135	123	114	108	115	115	121
Performance ratios:								
Return on average equity	10.33 %	10.78	10.74	9.47	9.30	9.22	12.06	8.86
Return on average assets	0.92 %	0.95	1.00	0.87	0.88	0.86	1.07	0.77
Dividend payout ratio	44.68 %	42.86	40.38	45.65	44.57	46.59	36.61	51.25
Average equity to average assets	8.95 %	8.85	9.32	9.17	9.45	9.33	8.85	8.74
Asset Quality:								
Allowance for loan losses as a % of:								
Loans	1.37 %	1.56	1.65	1.73	1.69	1.52	1.63	1.97
Nonperforming loans	124 %	134	138	143	64	44	79	73
Nonperforming assets as a % of:								
Loans and foreclosed properties	2.10 %	2.34	2.10	2.42	3.83	4.61	3.31	4.53
Total assets	1.08 %	1.21	1.08	1.24	2.03	2.46	1.75	2.31
Nonperforming loans as % of loans	1.11 %	1.16	1.19	1.22	2.65	3.43	2.06	2.69
Net charge-offs as % of average loans (c)	0.71 %	0.53	0.32	0.36	0.39	2.00	1.61	0.02
Capital Adequacy:								
Tier 1 risk-based capital ratio	17.19 %	17.29	16.45	16.32	16.20	15.75	15.39	15.69
Total risk-based capital ratio	18.40 %	18.55	17.70	17.57	17.46	17.00	16.65	16.95
Tier 1 Leverage ratio	10.10 %	9.96	9.76	9.42	9.58	9.54	9.26	9.06
Other financial data:								
Net interest margin (a)	3.20 %	3.19	3.16	3.09	3.22	3.23	3.26	3.11
Effective income tax rate	22.46 %	26.19	26.06	22.17	18.02	17.74	18.12	14.97
Efficiency ratio (b)	66.85 %	60.60	61.61	58.87	53.58	49.01	53.67	73.37
Selected period end balances:								
Securities	\$ 271,219	259,467	270,794	270,219	259,475	254,819	277,246	299,902
Loans, net of unearned income	383,339	380,705	390,726	390,570	398,193	397,738	399,370	380,377
Allowance for loan losses	5,268	5,946	6,457	6,769	6,723	6,045	6,503	7,496
Total assets	751,343	744,602	767,747	772,155	759,833	753,467	766,161	760,522
Total deposits	668,844	650,421	666,490	659,056	636,817	629,824	644,246	641,195
Long-term debt	12,217	22,217	27,217	37,217	47,217	47,217	47,217	47,308
Total stockholders' equity	64,485	65,807	65,211	70,217	70,149	70,206	68,292	65,972

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

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

(c) Net charge-offs are annualized.

Table 4 - Average Balance and Net Interest Income Analysis

	Year ended December 31								
	2013			2012			2011		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<i>(Dollars in thousands)</i>									
Interest-earning assets:									
Loans and loans held for sale (1)	\$ 390,288	\$ 20,604	5.28%	\$ 395,938	\$ 21,943	5.54%	\$ 376,000	\$ 21,306	5.67%
Securities - taxable	195,850	3,912	2.00%	199,794	3,883	1.94%	223,638	6,006	2.69%
Securities - tax-exempt (2)	67,797	4,234	6.25%	77,447	4,829	6.24%	79,329	5,056	6.37%
Total securities	263,647	8,146	3.09%	277,241	8,712	3.14%	302,967	11,062	3.65%
Federal funds sold	48,671	106	0.22%	27,466	54	0.20%	28,905	56	0.19%
Interest bearing bank deposits	5,634	42	0.75%	793	—	—	1,394	1	0.05%
Total interest-earning assets	708,240	28,898	4.08%	701,438	30,709	4.38%	709,266	32,425	4.57%
Cash and due from banks	13,694			14,125			13,054		
Other assets	37,836			39,742			48,796		
Total assets	<u>\$ 759,770</u>			<u>\$ 755,305</u>			<u>\$ 771,116</u>		
Interest-bearing liabilities:									
Deposits:									
NOW	\$ 101,034	319	0.32%	\$ 99,664	349	0.35%	\$ 90,565	527	0.58%
Savings and money market	171,413	886	0.52%	153,668	859	0.56%	138,428	996	0.72%
Certificates of deposits									
less than \$100,000	105,631	1,437	1.36%	108,726	1,769	1.63%	114,490	2,227	1.95%
Certificates of deposits and other time deposits of									
\$100,000 or more	155,781	2,750	1.77%	161,128	3,347	2.08%	181,242	4,318	2.38%
Total interest-bearing deposits	533,859	5,392	1.01%	523,186	6,324	1.21%	524,725	8,068	1.54%
Short-term borrowings	2,817	14	0.50%	2,970	16	0.54%	2,423	12	0.50%
Long-term debt	31,518	1,130	3.59%	49,115	1,830	3.73%	86,899	3,401	3.91%
Total interest-bearing	568,194	6,536	1.15%	575,271	8,170	1.42%	614,047	11,481	1.87%
Noninterest-bearing deposits	119,136			107,948			92,764		
Other liabilities	3,522			3,410			3,463		
Stockholders' equity	68,918			68,676			60,842		
Total liabilities and stockholders' equity	<u>\$ 759,770</u>			<u>\$ 755,305</u>			<u>\$ 771,116</u>		
Net interest income and margin		<u>\$ 22,362</u>	<u>3.16%</u>		<u>\$ 22,539</u>	<u>3.21%</u>		<u>\$ 20,944</u>	<u>2.95%</u>

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

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

Table 5 - Volume and Rate Variance Analysis

<i>(Dollars in thousands)</i>	<u>Years ended December 31, 2013 vs. 2012</u>			<u>Years ended December 31, 2012 vs. 2011</u>		
	<u>Net</u>	<u>Due to change in</u>		<u>Net</u>	<u>Due to change in</u>	
		<u>Change</u>	<u>Rate (2)</u>		<u>Volume (2)</u>	<u>Change</u>
Interest income:						
Loans and loans held for sale	\$ (1,339)	(1,041)	(298)	\$ 637	(468)	1,105
Securities - taxable	29	108	(79)	(2,123)	(1,660)	(463)
Securities - tax-exempt (1)	(595)	8	(603)	(227)	(110)	(117)
Total securities	(566)	116	(682)	(2,350)	(1,770)	(580)
Federal funds sold	52	6	46	(2)	1	(3)
Interest bearing bank deposits	42	6	36	(1)	(1)	—
Total interest income	\$ (1,811)	(913)	(898)	\$ (1,716)	(2,238)	522
Interest expense:						
Deposits:						
NOW	\$ (30)	(35)	5	\$ (178)	(210)	32
Savings and money market	27	(65)	92	(137)	(222)	85
Certificates of deposits less than \$100,000	(332)	(290)	(42)	(458)	(364)	(94)
Certificates of deposits and other time deposits of \$100,000 or more	(597)	(503)	(94)	(971)	(553)	(418)
Total interest-bearing deposits	(932)	(893)	(39)	(1,744)	(1,349)	(395)
Short-term borrowings	(2)	(1)	(1)	4	1	3
Long-term debt	(700)	(69)	(631)	(1,571)	(163)	(1,408)
Total interest expense	(1,634)	(963)	(671)	(3,311)	(1,511)	(1,800)
Net interest income	\$ (177)	50	(227)	\$ 1,595	(727)	2,322

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

(2) Changes that are not solely a result of volume or rate have been allocated to volume.

Table 6 - Loan Portfolio Composition

<i>(In thousands)</i>	December 31				
	2013	2012	2011	2010	2009
Commercial and industrial	\$ 57,780	59,334	54,988	53,288	53,884
Construction and land development	36,479	37,631	39,814	47,850	56,820
Commercial real estate	174,920	183,611	162,435	166,241	156,928
Residential real estate	101,706	105,631	101,725	96,241	97,407
Consumer installment	12,893	12,219	11,454	10,676	11,236
Total loans	383,778	398,426	370,416	374,296	376,275
Less: unearned income	(439)	(233)	(153)	(81)	(172)
Loans, net of unearned income	383,339	398,193	370,263	374,215	376,103
Less: allowance for loan losses	(5,268)	(6,723)	(6,919)	(7,676)	(6,495)
Loans, net	\$ 378,071	391,470	363,344	366,539	369,608

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

	December 31, 2013						
<i>(Dollars in thousands)</i>	1 year or less	1 to 5 years	After 5 years	Total	Adjustable Rate	Fixed Rate	Total
Commercial and industrial	\$ 4,927	47,697	5,156	57,780	36,015	21,765	57,780
Construction and land development	3,018	27,117	6,344	36,479	19,154	17,325	36,479
Commercial real estate	60	70,128	104,732	174,920	25,587	149,333	174,920
Residential real estate	556	28,761	72,389	101,706	51,386	50,320	101,706
Consumer installment	51	11,340	1,502	12,893	3,127	9,766	12,893
Total loans	\$ 8,612	185,043	190,123	383,778	135,269	248,509	383,778

Table 8 - Allowance for Loan Losses and Nonperforming Assets

<i>(Dollars in thousands)</i>	Year ended December 31				
	2013	2012	2011	2010	2009
Allowance for loan losses:					
Balance at beginning of period	\$ 6,723	6,919	7,676	6,495	4,398
Charge-offs:					
Commercial and industrial	(514)	(289)	(679)	(537)	(495)
Construction and land development	(39)	(231)	(1,758)	(1,487)	(2,088)
Commercial real estate	(262)	(3,184)	(422)	—	—
Residential real estate	(808)	(545)	(533)	(552)	(704)
Consumer installment	(397)	(85)	(21)	(111)	(61)
Total charge-offs	(2,020)	(4,334)	(3,413)	(2,687)	(3,348)
Recoveries:					
Commercial and industrial	48	54	34	63	47
Construction and land development	6	46	2	54	50
Commercial real estate	4	71	—	—	—
Residential real estate	88	134	155	151	92
Consumer installment	19	18	15	20	6
Total recoveries	165	323	206	288	195
Net charge-offs	(1,855)	(4,011)	(3,207)	(2,399)	(3,153)
Provision for loan losses	400	3,815	2,450	3,580	5,250
Ending balance	\$ 5,268	6,723	6,919	7,676	6,495
as a % of loans	1.37 %	1.69	1.87	2.05	1.73
as a % of nonperforming loans	124 %	64	67	65	69
Net charge-offs as % of average loans	0.48 %	1.03	0.86	0.64	0.84
Nonperforming assets:					
Nonaccrual/nonperforming loans	\$ 4,261	10,535	10,354	11,833	9,352
Other real estate owned	3,884	4,919	7,898	8,125	7,292
Total nonperforming assets	\$ 8,145	15,454	18,252	19,958	16,644
as a % of loans and foreclosed properties	2.10 %	3.83	4.83	5.22	4.34
as a % total assets	1.08 %	2.03	2.35	2.61	2.15
Nonperforming loans as a % of total loans	1.11 %	2.65	2.80	3.16	2.49
Accruing loans 90 days or more past due	\$ 73	58	—	—	5

Table 9 - Allocation of Allowance for Loan Losses

<i>(Dollars in thousands)</i>	December 31									
	2013		2012		2011		2010		2009	
	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial and industrial	\$ 386	15.1	\$ 812	14.9	\$ 948	14.8	\$ 972	14.2	\$ 784	14.3
Construction and land development	366	9.5	1,545	9.4	1,470	10.7	2,223	12.8	2,063	15.1
Commercial real estate	3,186	45.6	3,137	46.1	3,009	43.9	2,893	44.4	1,264	41.7
Residential real estate	1,114	26.5	1,126	26.5	1,363	27.5	1,336	25.7	1,706	25.9
Consumer installment	216	3.4	103	3.1	129	3.1	141	2.9	227	3.0
Unallocated	—		—		—		111		451	
Total allowance for loan losses	\$ 5,268		\$ 6,723		\$ 6,919		\$ 7,676		\$ 6,495	

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

Table 10 - CDs and Other Time Deposits of \$100,000 or More*(Dollars in thousands)***December 31, 2013****Maturity of:**

3 months or less	\$	15,642
Over 3 months through 6 months		15,136
Over 6 months through 12 months		40,886
Over 12 months		84,571
Total CDs and other time deposits of \$100,000 or more (1)		\$ 156,235

(1) includes brokered certificates of deposit.

Management's Report on Internal Control Over Financial Reporting

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

Under the direction of the Company's Chief Executive Officer and Principal Financial and Accounting Officer, management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013 in accordance with the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, management has concluded that such internal control over financial reporting was effective as of December 31, 2013.

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

Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Auburn National Bancorporation, Inc. and subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of earnings, comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Auburn National Bancorporation, Inc. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2013 in conformity with U.S. generally accepted accounting principles.

KPMG LLP

Birmingham, Alabama
March 24, 2014

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES
Consolidated Balance Sheets

	December 31	
<i>(Dollars in thousands, except share data)</i>	2013	2012
Assets:		
Cash and due from banks	\$ 13,437	\$ 18,762
Federal funds sold	26,965	42,682
Interest bearing bank deposits	13,820	505
Cash and cash equivalents	54,222	61,949
Securities available-for-sale	271,219	259,475
Loans held for sale	2,296	2,887
Loans, net of unearned income	383,339	398,193
Allowance for loan losses	(5,268)	(6,723)
Loans, net	378,071	391,470
Premises and equipment, net	10,442	10,528
Bank-owned life insurance	17,503	17,076
Other real estate owned	3,884	4,919
Other assets	13,706	11,529
Total assets	\$ 751,343	\$ 759,833
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 125,740	\$ 118,014
Interest-bearing	543,104	518,803
Total deposits	668,844	636,817
Federal funds purchased and securities sold under agreements to repurchase	3,363	2,689
Long-term debt	12,217	47,217
Accrued expenses and other liabilities	2,434	2,961
Total liabilities	686,858	689,684
Stockholders' equity:		
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	3,759	3,756
Retained earnings	71,879	67,821
Accumulated other comprehensive (loss) income, net	(4,552)	5,174
Less treasury stock, at cost - 314,017 shares and 314,232 shares at December 31, 2013 and 2012, respectively	(6,640)	(6,641)
Total stockholders' equity	64,485	70,149
Total liabilities and stockholders' equity	\$ 751,343	\$ 759,833

See accompanying notes to consolidated financial statements

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

<i>(Dollars in thousands, except share and per share data)</i>	Year ended December 31		
	2013	2012	2011
Interest income:			
Loans, including fees	\$ 20,604	\$ 21,943	\$ 21,306
Securities	6,706	7,070	9,343
Federal funds sold and interest bearing bank deposits	148	54	57
Total interest income	27,458	29,067	30,706
Interest expense:			
Deposits	5,392	6,324	8,068
Short-term borrowings	14	16	12
Long-term debt	1,130	1,830	3,401
Total interest expense	6,536	8,170	11,481
Net interest income	20,922	20,897	19,225
Provision for loan losses	400	3,815	2,450
Net interest income after provision for loan losses	20,522	17,082	16,775
Noninterest income:			
Service charges on deposit accounts	930	1,111	1,167
Mortgage lending	2,895	3,445	1,922
Bank-owned life insurance	427	445	460
Gain on sale of affordable housing investments	—	3,268	—
Affordable housing investment losses	—	—	(646)
Gain on sale of premises and equipment	1,018	—	—
Other	1,377	1,535	1,396
Securities gains, net:			
Realized gains, net	651	809	1,216
Total other-than-temporary impairments	—	(130)	(468)
Non-credit portion of other-than-temporary impairments recognized in other comprehensive income	—	—	130
Total securities gains, net	651	679	878
Total noninterest income	7,298	10,483	5,177
Noninterest expense:			
Salaries and benefits	8,788	8,691	8,167
Net occupancy and equipment	1,335	1,332	1,404
Professional fees	774	704	735
FDIC and other regulatory assessments	512	686	792
Other real estate owned, net	570	323	2,007
Prepayment penalties on long-term debt	3,028	3,720	—
Other	3,405	3,927	3,252
Total noninterest expense	18,412	19,383	16,357
Earnings before income taxes	9,408	8,182	5,595
Income tax expense	2,290	1,419	57
Net earnings	\$ 7,118	\$ 6,763	\$ 5,538
Net earnings per share:			
Basic and diluted	\$ 1.95	\$ 1.86	\$ 1.52
Weighted average shares outstanding:			
Basic and diluted	3,643,003	3,642,831	3,642,735

See accompanying notes to consolidated financial statements

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

	Year ended December 31		
<i>(Dollars in thousands)</i>	2013	2012	2011
Net earnings	\$ 7,118	\$ 6,763	\$ 5,538
Other comprehensive (loss) income, net of tax:			
Unrealized net holding loss on other-than-temporarily impaired securities due to factors other than credit	—	—	(82)
Unrealized net holding (loss) gain on all other securities	(9,315)	1,379	7,959
Reclassification adjustment for net gain on securities recognized in net earnings	(411)	(427)	(554)
Other comprehensive (loss) income	(9,726)	952	6,423
Comprehensive (loss) income	\$ (2,608)	\$ 7,715	\$ 11,961

See accompanying notes to consolidated financial statements

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

	<u>Common Stock</u>		Additional paid-in capital	Retained earnings	Accumulated other comprehensive		Treasury stock	Total
	Shares	Amount			(loss)	income		
<i>(Dollars in thousands, except share data)</i>								
Balance, December 31, 2010	3,957,135	\$ 39	\$ 3,752	\$ 61,421	\$ (2,201)	\$ (6,643)	\$	56,368
Net earnings	—	—	—	5,538	—	—	—	5,538
Other comprehensive income	—	—	—	—	6,423	—	—	6,423
Cash dividends paid (\$0.80 per share)	—	—	—	(2,914)	—	—	—	(2,914)
Sale of treasury stock (20 shares)	—	—	1	—	—	—	—	1
Balance, December 31, 2011	3,957,135	\$ 39	\$ 3,753	\$ 64,045	\$ 4,222	\$ (6,643)	\$	65,416
Net earnings	—	—	—	6,763	—	—	—	6,763
Other comprehensive income	—	—	—	—	952	—	—	952
Cash dividends paid (\$0.82 per share)	—	—	—	(2,987)	—	—	—	(2,987)
Sale of treasury stock (165 shares)	—	—	3	—	—	—	2	5
Balance, December 31, 2012	3,957,135	\$ 39	\$ 3,756	\$ 67,821	\$ 5,174	\$ (6,641)	\$	70,149
Net earnings	—	—	—	7,118	—	—	—	7,118
Other comprehensive loss	—	—	—	—	(9,726)	—	—	(9,726)
Cash dividends paid (\$0.84 per share)	—	—	—	(3,060)	—	—	—	(3,060)
Sale of treasury stock (215 shares)	—	—	3	—	—	—	1	4
Balance, December 31, 2013	3,957,135	\$ 39	\$ 3,759	\$ 71,879	\$ (4,552)	\$ (6,640)	\$	64,485

See accompanying notes to consolidated financial statements

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows

<i>(In thousands)</i>	Year ended December 31		
	2013	2012	2011
Cash flows from operating activities:			
Net earnings	\$ 7,118	\$ 6,763	\$ 5,538
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Provision for loan losses	400	3,815	2,450
Depreciation and amortization	827	837	665
Premium amortization and discount accretion, net	1,956	2,992	2,445
Deferred tax expense (benefit)	1,537	624	(368)
Net gain on securities available for sale	(651)	(679)	(878)
Net gain on sale of loans held for sale	(2,030)	(3,430)	(1,680)
Net loss on other real estate owned	477	245	1,830
Loss on prepayment of long-term debt	3,028	3,720	—
Loans originated for sale	(94,980)	(154,044)	(71,350)
Proceeds from sale of loans	96,779	156,967	73,550
Net gain on disposition of premises and equipment	(1,018)	—	—
Increase in cash surrender value of bank owned life insurance	(427)	(445)	(460)
Gain on sale of affordable housing partnership investments	—	(3,268)	—
Loss on affordable housing partnership investments	—	—	646
Net decrease in other assets	1,232	1,131	1,015
Net (decrease) increase in accrued expenses and other liabilities	(527)	(171)	685
Net cash provided by operating activities	\$ 13,721	\$ 15,057	\$ 14,088
Cash flows from investing activities:			
Proceeds from sales of securities available-for-sale	40,251	57,650	128,715
Proceeds from maturities of securities available-for-sale	54,737	112,005	95,641
Purchase of securities available-for-sale	(123,449)	(130,352)	(200,106)
Decrease (increase) in loans, net	10,721	(33,456)	(2,824)
Net purchases of premises and equipment	(462)	(1,549)	(1,568)
Decrease in FHLB stock	1,153	2,067	856
Capital contributions to affordable housing limited partnerships	—	—	(4,378)
Proceeds from sale of affordable housing limited partnerships	—	8,499	—
Proceeds from sale of premises and equipment	1,148	—	—
Proceeds from sale of other real estate owned	2,836	4,249	1,966
Net cash (used in) provided by investing activities	\$ (13,065)	\$ 19,113	\$ 18,302
Cash flows from financing activities:			
Net increase in noninterest-bearing deposits	7,726	11,738	18,616
Net increase (decrease) in interest-bearing deposits	24,301	5,527	(6,191)
Net increase (decrease) in federal funds purchased and securities under agreements to repurchase	674	(116)	120
Repayments or retirement of long-term debt	(38,028)	(41,816)	(8,018)
Proceeds from sale of treasury stock	4	5	1
Dividends paid	(3,060)	(2,987)	(2,914)
Net cash (used in) provided by financing activities	\$ (8,383)	\$ (27,649)	\$ 1,614
Net change in cash and cash equivalents	\$ (7,727)	\$ 6,521	\$ 34,004
Cash and cash equivalents at beginning of period	61,949	55,428	21,424
Cash and cash equivalents at end of period	\$ 54,222	\$ 61,949	\$ 55,428
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Interest	\$ 6,761	\$ 8,535	\$ 11,713
Income taxes	758	1,224	347
Supplemental disclosure of non-cash transactions:			
Real estate acquired through foreclosure	\$ 2,278	\$ 1,515	\$ 3,569

See accompanying notes to consolidated financial statements

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

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

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Auburn National Bancorporation Capital Trust I is an affiliate of the Company and was included in these consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

Use of Estimates

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

In the first quarter of 2013, the Company adopted new guidance related to the following Accounting Standards Updates (“Updates” or “ASUs”):

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

In the third quarter of 2013, the Company adopted new guidance related to the following Update:

- ASU 2013-10, *Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes*.

Information about these pronouncements is described in more detail below.

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

ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, seeks to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments in this Update require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. GAAP to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net

income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. These changes were effective for the Company in the first quarter of 2013 with retrospective application. This Update did not affect our consolidated financial results as it amends only the presentation of comprehensive income. See Consolidated Statements of Comprehensive Income.

ASU 2013-10, *Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes*, permits the Fed Funds Effective Swap Rate (Overnight Index Swap Rate) to be used as a U.S. benchmark interest rate for hedge accounting purposes, in addition to LIBOR and U.S. Treasury. The ASU also removes the restriction on using different benchmark rates for similar hedges. These changes are effective for the Company in the third quarter of 2013 with prospective application for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. Adoption of this ASU did not have a significant impact on the financial statements of the Company.

Cash Equivalents

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

Securities

Securities are classified based on management's intention at the date of purchase. At December 31, 2013, all of the Company's securities were classified as available-for-sale. Securities available-for-sale are used as part of the Company's interest rate risk management strategy, and they may be sold in response to changes in interest rates, changes in prepayment risks or other factors. All securities classified as available-for-sale are recorded at fair value with any unrealized gains and losses reported in accumulated other comprehensive loss, net of the deferred income tax effects. Interest and dividends on securities, including the amortization of premiums and accretion of discounts are recognized in interest income over the anticipated life of the security using the effective interest method, taking into consideration prepayment assumptions. Realized gains and losses from the sale of securities are determined using the specific identification method.

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

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

Loans held for sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Loan sales are recognized when the transaction closes, the proceeds are collected, and ownership is transferred. Continuing involvement, through the sales agreement, consists of the right to service the loan for a fee for the life of the loan, if applicable. Gains on the sale of loans held for sale are recorded net of related costs, such as commissions, and reflected as a component of mortgage lending income in the consolidated statements of earnings.

In the course of conducting the Bank's mortgage lending activities of originating mortgage loans and selling those loans in the secondary market, the Bank makes various representations and warranties to the purchaser of the mortgage loans. Every loan closed by the Bank's mortgage center is run through a government agency automated underwriting system. Any exceptions noted during this process are remedied prior to sale. These representations and warranties also apply to underwriting the real estate appraisal opinion of value for the collateral securing these loans. Failure by the Company to comply with the underwriting and/or appraisal standards could result in the Company being required to repurchase the mortgage loan or to reimburse the investor for losses incurred (make whole requests) if such failure cannot be cured by the Company within the specified period following discovery. In 2012, we repurchased one residential mortgage loan with an unpaid principal balance of \$0.3 million. This loan was current as to principal and interest at the time of repurchase, and we incurred no losses upon repurchase. Except for this loan, during 2013, 2012, and 2011, no loans were repurchased and no reimbursements for investor losses were made by the Company.

Loans

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

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

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

Impaired loans also included troubled debt restructurings ("TDRs"). In the normal course of business, management may grant concessions to borrowers who are experiencing financial difficulty. The concessions granted most frequently for TDRs involve reductions or delays in required payments of principal and interest for a specified time, the rescheduling of payments in accordance with a bankruptcy plan or the charge-off of a portion of the loan. In most cases, the conditions of the credit also warrant nonaccrual status, even after the restructuring occurs. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructuring. TDR loans may be returned to accrual status if there has been at least a six-month sustained period of repayment performance by the borrower.

Allowance for Loan Losses

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

Premises and Equipment

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

Other Real Estate Owned

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

Nonmarketable equity investments

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

Transfers of Financial Assets

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

Mortgage Servicing Rights

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

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

Derivative Instruments

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

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

Securities sold under agreements to repurchase

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

Income Taxes

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. The net deferred tax asset is reflected as a component of other assets in the accompanying consolidated balance sheets.

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

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

Fair Value Measurements

ASC 820, which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. ASC 820 applies only to fair-value measurements that are already required or permitted by other accounting standards. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. For more information related to fair value measurements, please refer to Note 17, Fair Value.

Subsequent Events

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to December 31, 2013. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

NOTE 2: BASIC AND DILUTED EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the year. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company's common stock. As of December 31, 2013, 2012, and 2011, respectively, the Company had no such securities or rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted earnings per share calculation.

The basic and diluted earnings per share computations for the respective years are presented below.

<i>(Dollars in thousands, except share and per share data)</i>	Year ended December 31		
	2013	2012	2011
Basic and diluted:			
Net earnings	\$ 7,118	\$ 6,763	\$ 5,538
Weighted average common shares outstanding	3,643,003	3,642,831	3,642,735
Earnings per share	\$ 1.95	\$ 1.86	\$ 1.52

NOTE 3: VARIABLE INTEREST ENTITIES

Generally, a variable interest entity ("VIE") is a corporation, partnership, trust or other legal structure that does not have equity investors with substantive or proportional voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities.

At December 31, 2013, the Company did not have any consolidated VIEs to disclose but did have one nonconsolidated VIE, discussed below.

Trust Preferred Securities

The Company owns the common stock of a subsidiary business trust, Auburn National Bancorporation Capital Trust I, which issued mandatorily redeemable preferred capital securities ("trust preferred securities") in the aggregate of approximately \$7.0 million at the time of issuance. This trust meets the definition of a VIE of which the Company is not the primary beneficiary; the trust's only assets are junior subordinated debentures issued by the Company, which were acquired by the trust using the proceeds from the issuance of the trust preferred securities and common stock. The junior subordinated debentures of approximately \$7.2 million are included in long-term debt and the Company's equity interest of \$0.2 million in the business trust is included in other assets. Interest expense on the junior subordinated debentures is included in interest expense on long-term debt.

The following table summarizes VIEs that are not consolidated by the Company as of December 31, 2013.

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

NOTE 4: RESTRICTED CASH BALANCES

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. As of December 31, 2013 and 2012, the Bank did not have a required reserve balance at the Federal Reserve Bank.

NOTE 5: SECURITIES

At December 31, 2013 and 2012, respectively, all securities within the scope of ASC 320, *Investments – Debt and Equity Securities* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity December 31, 2013 and 2012, respectively, are presented below.

<i>(Dollars in thousands)</i>		1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized		Amortized Cost
							Gains	Losses	
December 31, 2013									
Agency obligations (a)	\$	—	—	23,247	21,275	44,522	—	4,557	\$ 49,079
Agency RMBS (a)		—	—	8,306	154,052	162,358	976	4,733	166,115
State and political subdivisions		—	1,735	21,366	41,238	64,339	1,560	459	63,238
Total available-for-sale	\$	—	1,735	52,919	216,565	271,219	2,536	9,749	\$ 278,432
December 31, 2012									
Agency obligations (a)	\$	—	—	20,065	19,460	39,525	187	19	\$ 39,357
Agency RMBS (a)		—	—	4,700	136,760	141,460	3,012	162	138,610
State and political subdivisions		111	1,830	21,006	54,891	77,838	5,222	—	72,616
Trust preferred securities		—	—	—	652	652	113	154	693
Total available-for-sale	\$	111	1,830	45,771	211,763	259,475	8,534	335	\$ 251,276

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

Securities with aggregate fair values of \$120.5 million and \$134.0 million at December 31, 2013 and 2012, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (“FHLB”) advances, and for other purposes required or permitted by law.

Included in other assets on the accompanying consolidated balance sheets are cost-method investments. The carrying amounts of cost-method investments were \$1.8 and \$3.0 million at December 31, 2013 and 2012, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (“FRB”) stock.

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at December 31, 2013 and 2012, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or more are presented below.

<i>(Dollars in thousands)</i>		Less than 12 Months		12 Months or Longer		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2013:							
Agency obligations	\$	35,933	3,182	8,590	1,376	44,523	\$ 4,558
Agency RMBS		109,774	4,393	7,683	339	117,457	4,732
State and political subdivisions		9,575	459	—	—	9,575	459
Total	\$	155,282	8,034	16,273	1,715	171,555	\$ 9,749
December 31, 2012:							
Agency obligations	\$	9,966	19	—	—	9,966	\$ 19
Agency RMBS		25,207	162	—	—	25,207	162
Trust preferred securities		—	—	346	154	346	154
Total	\$	35,173	181	346	154	35,519	\$ 335

For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. The Company assesses each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities' amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

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

- the length of time and the extent to which the fair value has been less than the amortized cost basis;
- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);
- the historical and implied volatility of the fair value of the security;
- the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency; and
- recoveries or additional declines in fair value subsequent to the balance sheet date.

Agency obligations

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

Agency residential mortgage-backed securities ("RMBS")

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

Securities of U.S. states and political subdivisions

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

Cost-method investments

At December 31, 2013, cost-method investments with an aggregate cost of \$1.8 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

The carrying values of the Company's investment securities could decline in the future if the financial condition of an issuer deteriorates and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that significant other-than-temporary impairment charges may occur in the future.

Other-Than-Temporarily Impaired Securities

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and the credit component of the loss is recognized in earnings (referred to as “credit-impaired” debt securities). Other-than-temporary impairments recognized in earnings for the years ended 2013, 2012, and 2011, for credit-impaired debt securities are presented as additions in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). The credit loss component is reduced if the Company sells, intends to sell, or believes it will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if the Company receives cash flows in excess of what it expected to receive over the remaining life of the credit-impaired debt security, the security matures or the security is fully written-down and deemed worthless. Changes in the credit loss component of credit-impaired debt securities were:

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Balance, beginning of period	\$ 1,257	3,276	2,938
Additions:			
Subsequent credit impairments	—	130	338
Reductions:			
Securities sold	(757)	(2,149)	—
Securities fully written down and deemed worthless	(500)	—	—
Balance, end of period	\$ —	1,257	3,276

Other-Than-Temporary Impairment

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

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Other-than-temporary impairment charges (included in earnings):			
Debt securities:			
Individual issuer trust preferred securities	\$ —	130	338
Total debt securities	\$ —	130	338
Total other-than-temporary impairment charges (included in earnings)	\$ —	130	338
Other-than-temporary impairment on debt securities:			
Recorded as part of gross realized losses:			
Credit-related	\$ —	130	338
Securities with intent to sell	—	—	—
Recorded directly to other comprehensive income for non-credit related impairment	—	—	130
Total other-than-temporary impairment on debt securities	\$ —	130	468

Realized Gains and Losses

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

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Gross realized gains	\$ 745	1,005	1,698
Gross realized losses	(94)	(196)	(482)
Other-than-temporary impairment charges	—	(130)	(338)
Realized gains, net	\$ 651	679	878

NOTE 6: LOANS AND ALLOWANCE FOR LOAN LOSSES

	December 31	
<i>(In thousands)</i>	2013	2012
Commercial and industrial	\$ 57,780	\$ 59,334
Construction and land development	36,479	37,631
Commercial real estate:		
Owner occupied	56,102	64,368
Other	118,818	119,243
Total commercial real estate	174,920	183,611
Residential real estate:		
Consumer mortgage	57,871	58,087
Investment property	43,835	47,544
Total residential real estate	101,706	105,631
Consumer installment	12,893	12,219
Total loans	383,778	398,426
Less: unearned income	(439)	(233)
Loans, net of unearned income	\$ 383,339	\$ 398,193

Loans secured by real estate were approximately 81.6% of the total loan portfolio at December 31, 2013. At December 31, 2013, the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

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

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

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

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

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

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

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

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

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

The following is a summary of current, accruing past due and nonaccrual loans by portfolio class as of December 31, 2013 and 2012.

<i>(In thousands)</i>	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non- Accrual	Total Loans
December 31, 2013:						
Commercial and industrial	\$ 57,558	167	—	57,725	55	\$ 57,780
Construction and land development	34,883	14	—	34,897	1,582	36,479
Commercial real estate:						
Owner occupied	54,214	861	—	55,075	1,027	56,102
Other	118,389	—	—	118,389	429	118,818
Total commercial real estate	172,603	861	—	173,464	1,456	174,920
Residential real estate:						
Consumer mortgage	56,191	745	69	57,005	866	57,871
Investment property	42,935	598	—	43,533	302	43,835
Total residential real estate	99,126	1,343	69	100,538	1,168	101,706
Consumer installment	12,789	100	4	12,893	—	12,893
Total	\$ 376,959	2,485	73	379,517	4,261	\$ 383,778
December 31, 2012:						
Commercial and industrial	\$ 59,101	173	—	59,274	60	\$ 59,334
Construction and land development	35,917	8	—	35,925	1,706	37,631
Commercial real estate:						
Owner occupied	63,323	—	—	63,323	1,045	64,368
Other	113,344	230	—	113,574	5,669	119,243
Total commercial real estate	176,667	230	—	176,897	6,714	183,611
Residential real estate:						
Consumer mortgage	55,521	1,202	58	56,781	1,306	58,087
Investment property	46,460	335	—	46,795	749	47,544
Total residential real estate	101,981	1,537	58	103,576	2,055	105,631
Consumer installment	12,157	62	—	12,219	—	12,219
Total	\$ 385,823	2,010	58	387,891	10,535	\$ 398,426

The gross interest income which would have been recorded under the original terms of those nonaccrual loans had they been accruing interest, amounted to approximately \$270 thousand, \$511 thousand and \$494 thousand for the years ended December 31, 2013, 2012, and 2011, respectively.

Allowance for Loan Losses

The allowance for loan losses as of and for the years ended December 31, 2013, 2012 and 2011, is presented below.

<i>(In thousands)</i>	Year ended December 31		
	2013	2012	2011
Beginning balance	\$ 6,723	\$ 6,919	\$ 7,676
Charged-off loans	(2,020)	(4,334)	(3,413)
Recovery of previously charged-off loans	165	323	206
Net charge-offs	(1,855)	(4,011)	(3,207)
Provision for loan losses	400	3,815	2,450
Ending balance	\$ 5,268	\$ 6,723	\$ 6,919

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

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

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan's effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

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

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

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

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2013 and 2012, and for the years then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

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

The Company regularly re-evaluates its practices in determining the allowance for loan losses. During 2013, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 quarter historical period. Beginning with the quarter ended June 30, 2013, the Company calculated average losses for all loan segments (except for the commercial real estate loan segment) using a rolling 8 quarter historical period in order to better capture the effects of the current economic cycle on the Company's loan loss experience and continued this methodology through December 31, 2013. Based upon management's review of charge-off trends for each loan segment, the Company continues to calculate average losses for the commercial real estate loan segment using a rolling 6 quarter historical period. Other than the changes discussed above, the Company has not made any changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

The following table details the changes in the allowance for loan losses by portfolio segment for the years ended December 31, 2013, 2012, and 2011.

<i>(in thousands)</i>	Commercial and industrial	Construction and land Development	Commercial Real Estate	Residential Real Estate	Consumer Installment	Unallocated	Total
Balance, December 31, 2010	\$ 972	2,223	2,893	1,336	141	111	\$ 7,676
Charge-offs	(679)	(1,758)	(422)	(533)	(21)	—	(3,413)
Recoveries	34	2	—	155	15	—	206
Net charge-offs	(645)	(1,756)	(422)	(378)	(6)	—	(3,207)
Provision	621	1,003	538	405	(6)	(111)	2,450
Balance, December 31, 2011	\$ 948	1,470	3,009	1,363	129	—	\$ 6,919
Charge-offs	(289)	(231)	(3,184)	(545)	(85)	—	(4,334)
Recoveries	54	46	71	134	18	—	323
Net charge-offs	(235)	(185)	(3,113)	(411)	(67)	—	(4,011)
Provision	99	260	3,241	174	41	—	3,815
Balance, December 31, 2012	\$ 812	1,545	3,137	1,126	103	—	\$ 6,723
Charge-offs	(514)	(39)	(262)	(808)	(397)	—	(2,020)
Recoveries	48	6	4	88	19	—	165
Net charge-offs	(466)	(33)	(258)	(720)	(378)	—	(1,855)
Provision	40	(1,146)	307	708	491	—	400
Balance, December 31, 2013	\$ 386	366	3,186	1,114	216	—	\$ 5,268

The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of December 31, 2013 and 2012.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
	Allowance	Recorded	Allowance	Recorded	Allowance	Recorded
	for loan	investment	for loan	investment	for loan	investment
(In thousands)	losses	in loans	losses	in loans	losses	in loans
December 31, 2013:						
Commercial and industrial	\$ 386	57,656	—	124	386	57,780
Construction and land development	278	34,897	88	1,582	366	36,479
Commercial real estate	3,014	171,987	172	2,933	3,186	174,920
Residential real estate	1,114	100,780	—	926	1,114	101,706
Consumer installment	216	12,893	—	—	216	12,893
Total	\$ 5,008	378,213	260	5,565	5,268	383,778
December 31, 2012:						
Commercial and industrial	\$ 812	59,165	—	169	812	59,334
Construction and land development	1,416	36,008	129	1,623	1,545	37,631
Commercial real estate	3,003	176,085	134	7,526	3,137	183,611
Residential real estate	1,126	104,414	—	1,217	1,126	105,631
Consumer installment	103	12,219	—	—	103	12,219
Total	\$ 6,460	387,891	263	10,535	6,723	398,426

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

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

Credit Quality Indicators

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

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

<i>(In thousands)</i>	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
December 31, 2013					
Commercial and industrial	\$ 53,060	4,183	482	55	\$ 57,780
Construction and land development	33,616	180	1,101	1,582	36,479
Commercial real estate:					
Owner occupied	53,430	770	875	1,027	56,102
Other	117,490	91	808	429	118,818
Total commercial real estate	170,920	861	1,683	1,456	174,920
Residential real estate:					
Consumer mortgage	50,392	1,137	5,476	866	57,871
Investment property	40,517	1,310	1,706	302	43,835
Total residential real estate	90,909	2,447	7,182	1,168	101,706
Consumer installment	12,713	34	146	—	12,893
Total	\$ 361,218	7,705	10,594	4,261	\$ 383,778
December 31, 2012					
Commercial and industrial	\$ 58,487	224	563	60	\$ 59,334
Construction and land development	34,490	310	1,125	1,706	37,631
Commercial real estate:					
Owner occupied	59,270	2,528	1,525	1,045	64,368
Other	111,719	653	1,202	5,669	119,243
Total commercial real estate	170,989	3,181	2,727	6,714	183,611
Residential real estate:					
Consumer mortgage	49,462	1,544	5,775	1,306	58,087
Investment property	43,559	1,033	2,203	749	47,544
Total residential real estate	93,021	2,577	7,978	2,055	105,631
Consumer installment	11,850	155	214	—	12,219
Total	\$ 368,837	6,447	12,607	10,535	\$ 398,426

Impaired loans

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

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

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

<i>(In thousands)</i>	December 31, 2013			Related allowance
	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	
With no allowance recorded:				
Commercial and industrial	\$ 124	—	124	
Construction and land development	2,879	(1,682)	1,197	
Commercial real estate:				
Owner occupied	1,217	(190)	1,027	
Other	518	(89)	429	
Total commercial real estate	1,735	(279)	1,456	
Residential real estate:				
Consumer mortgages	952	(198)	754	
Investment property	207	(35)	172	
Total residential real estate	1,159	(233)	926	
Total	\$ 5,897	(2,194)	3,703	
With allowance recorded:				
Construction and land development	452	(67)	385	88
Commercial real estate:				
Owner occupied	875	—	875	110
Other	602	—	602	62
Total commercial real estate	1,477	—	1,477	172
Total	\$ 1,929	(67)	1,862	\$ 260
Total impaired loans	\$ 7,826	(2,261)	5,565	\$ 260

(1) Unpaid principal balance represents the contractual obligation due from the customer.

(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.

(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

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

(1) Unpaid principal balance represents the contractual obligation due from the customer.

(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.

(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

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

<i>(In thousands)</i>	Year ended December 31, 2013		Year ended December 31, 2012		Year ended December 31, 2011	
	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized
Impaired loans:						
Commercial and industrial	\$ 188	9	\$ 194	13	\$ 316	9
Construction and land development	1,603	—	3,888	—	4,136	—
Commercial real estate:						
Owner occupied	1,972	51	2,449	64	1,828	24
Other	1,454	12	2,621	—	2,374	—
Total commercial real estate	3,426	63	5,070	64	4,202	24
Residential real estate:						
Consumer mortgages	786	—	861	—	1,376	—
Investment property	274	—	652	—	146	—
Total residential real estate	1,060	—	1,513	—	1,522	—
Total	\$ 6,277	72	\$ 10,665	77	\$ 10,176	33

Troubled Debt Restructurings

Impaired loans also include troubled debt restructuring (“TDRs”). In the normal course of business, management may grant concessions to borrowers who are experiencing financial difficulty. A concession may include, but is not limited to, delays in required payments of principal and interest for a specified period, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date or reduction of the face amount or maturity amount of the debt. A concession has been granted when, as a result of the restructuring, the Bank does not expect to collect all amounts due, including interest at the original stated rate. A concession may have also been granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. In determining whether a loan modification is a TDR, the Company considers the individual facts and circumstances surrounding each modification. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructuring.

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

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

<i>(In thousands)</i>	TDRs			Related Allowance
	Accruing	Nonaccrual	Total	
December 31, 2013				
Commercial and industrial	\$ 124	—	124	\$ —
Construction and land development	—	1,582	1,582	88
Commercial real estate:				
Owner occupied	875	285	1,160	110
Other	602	429	1,031	62
Total commercial real estate	1,477	714	2,191	172
Residential real estate:				
Consumer mortgages	—	754	754	—
Investment property	—	172	172	—
Total residential real estate	—	926	926	—
Total	\$ 1,601	3,222	4,823	\$ 260
December 31, 2012				
Commercial and industrial	\$ 169	—	169	\$ —
Construction and land development	—	1,623	1,623	129
Commercial real estate:				
Owner occupied	899	1,045	1,944	134
Other	—	432	432	—
Total commercial real estate	899	1,477	2,376	134
Residential real estate:				
Consumer mortgages	—	819	819	—
Investment property	—	188	188	—
Total residential real estate	—	1,007	1,007	—
Total	\$ 1,068	4,107	5,175	\$ 263

At December 31, 2013, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

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

<i>(\$ in thousands)</i>	Number of contracts	Pre- modification outstanding recorded investment	Post- modification outstanding recorded investment
December 31, 2013			
Construction and land development	1	\$ 390	387
Commercial real estate:			
Owner occupied	1	882	882
Other	2	1,037	1,041
Total commercial real estate	3	1,919	1,923
Residential real estate:			
Consumer mortgages	3	849	844
Investment property	1	172	172
Total residential real estate	4	1,021	1,016
Total	8	\$ 3,330	3,326
December 31, 2012			
Construction and land development	4	\$ 5,419	4,305
Commercial real estate:			
Owner occupied	4	3,167	2,225
Other	2	1,803	1,657
Total commercial real estate	6	4,970	3,882
Residential real estate:			
Consumer mortgages	2	863	858
Investment property	2	567	563
Total residential real estate	4	1,430	1,421
Total	14	\$ 11,819	9,608
December 31, 2011			
Commercial and industrial	2	\$ 791	523
Construction and land development	3	4,925	4,894
Commercial real estate:			
Owner occupied	5	3,127	2,840
Other	1	1,229	1,229
Total commercial real estate	6	4,356	4,069
Residential real estate:			
Investment property	1	391	391
Total residential real estate	1	391	391
Total	12	\$ 10,463	9,877

The majority of the loans modified in a TDR during the years ended December 31, 2013, 2012, and 2011, respectively, included delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was not considered to be a market rate.

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

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

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

<i>(\$ in thousands)</i>	Number of Contracts	Recorded investment (1)
December 31, 2013		
Construction and land development	1	\$ 1,197
Commercial real estate:		
Other	1	425
Total commercial real estate	1	425
Total	2	\$ 1,622
December 31, 2012		
Construction and land development	1	\$ 2,386
Total	1	\$ 2,386
December 31, 2011		
Commercial real estate:		
Owner occupied	2	\$ 1,172
Other	1	1,201
Total commercial real estate	3	2,373
Total	3	\$ 2,373

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

NOTE 7: PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2013 and 2012 is presented below.

<i>(Dollars in thousands)</i>	December 31	
	2013	2012
Land	\$ 5,288	4,983
Buildings and improvements	8,539	9,110
Furniture, fixtures, and equipment	3,164	3,132
Total premises and equipment	16,991	17,225
Less: accumulated depreciation	(6,549)	(6,697)
Premises and equipment, net	\$ 10,442	10,528

Depreciation expense was approximately \$418 thousand, \$366 thousand, and \$328 thousand for the years ended December 31, 2013, 2012 and 2011, respectively, and is a component of net occupancy and equipment expense in the consolidated statements of earnings.

NOTE 8: MORTGAGE SERVICING RIGHTS, NET

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

The Company has recorded MSRs related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. MSRs are included in other assets on the accompanying consolidated balance sheets.

The Company periodically evaluates MSRs for impairment. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation allowance is established. The valuation allowance is adjusted

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as the fair value changes. Changes in the valuation allowance are recognized in earnings as a component of mortgage lending income.

The following table details the changes in amortized MSR and the related valuation allowance for the years ended December 31, 2013, 2012, and 2011.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Beginning balance	\$ 1,526	1,245	1,189
Additions, net	822	966	415
Amortization expense	(384)	(416)	(242)
Change in valuation allowance	386	(269)	(117)
Ending balance	\$ 2,350	1,526	1,245

Valuation allowance included in MSRs, net:

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

Fair value of amortized MSRs:

Beginning of period	\$ 1,526	1,245	1,335
End of period	3,452	1,526	1,245

Data and assumptions used in the fair value calculation related to MSRs at December 31, 2013 and 2012, respectively, are presented below.

<i>(Dollars in thousands)</i>	December 31	
	2013	2012
Unpaid principal balance	\$ 356,334	283,306
Weighted average prepayment speed (CPR)	7.5 %	23.7
Discount rate (annual percentage)	10.0 %	11.0
Weighted average coupon interest rate	3.9 %	3.9
Weighted average remaining maturity (months)	268	275
Weighted average servicing fee (basis points)	25.0	25.0

At December 31, 2013, the weighted average amortization period for MSRs was 7.5 years. Estimated amortization expense for each of the next five years is presented below.

<i>(Dollars in thousands)</i>	December 31, 2013
2014	\$ 313
2015	272
2016	242
2017	209
2018	183

NOTE 9: DEPOSITS

At December 31, 2013, the scheduled maturities of certificates of deposit and other time deposits are presented below.

<i>(Dollars in thousands)</i>	December 31, 2013
2014	\$ 128,615
2015	58,045
2016	17,739
2017	25,985
2018	20,384
Thereafter	10,431
Total certificates of deposit and other time deposits	\$ 261,199

Additionally, at December 31, 2013 and 2012, approximately \$156.2 and \$156.8 million, respectively, of certificates of deposit and other time deposits were issued in denominations of \$100,000 or greater.

At December 31, 2013 and 2012, the amount of deposit accounts in overdraft status that were reclassified to loans on the accompanying consolidated balance sheets was not material.

NOTE 10: SHORT-TERM BORROWINGS

At December 31, 2013, 2012, and 2011, the composition of short-term borrowings is presented below.

<i>(Dollars in thousands)</i>	2013		2012		2011	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
Federal funds purchased:						
As of December 31	\$ —	—	\$ —	—	\$ —	—
Average during the year	43	0.92 %	225	0.96 %	6	1.00 %
Maximum outstanding at any month-end	2,376		1,925		—	
Securities sold under agreements to repurchase:						
As of December 31	\$ 3,363	0.50 %	\$ 2,689	0.50 %	\$ 2,805	0.50 %
Average during the year	2,774	0.50 %	2,746	0.50 %	2,416	0.50 %
Maximum outstanding at any month-end	3,363		3,174		2,936	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling \$41.0 million with none outstanding at December 31, 2013.

Securities sold under agreements to repurchase represent short-term borrowings with maturities less than one year collateralized by a portion of the Company's securities portfolio. Securities with an aggregate carrying value of \$6.9 million and \$8.0 million at December 31, 2013 and 2012, respectively, were pledged to secure securities sold under agreements to repurchase.

NOTE 11: LONG-TERM DEBT

At December 31, 2013 and 2012, the composition of long-term debt is presented below.

<i>(Dollars in thousands)</i>	2013		2012	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
FHLB advances, due 2014 to 2018	\$ 5,000	3.59%	\$ 25,000	3.42%
Securities sold under agreements to repurchase, due 2017	—	—	15,000	4.21
Subordinated debentures, due 2033	7,217	3.38	7,217	3.38
Total long-term debt	\$ 12,217	3.47%	\$ 47,217	3.66%

The Bank had \$5.0 million and \$25.0 million of FHLB advances with original maturities greater than one year at December 31, 2013 and 2012, respectively. Securities with an aggregate carrying value of \$1.0 million and \$1.5 million and certain qualifying residential mortgage loans with an aggregate carrying value of \$42.1 million and \$45.5 million at December 31, 2013 and 2012, respectively, were pledged to secure long-term FHLB advances.

The Bank had no securities sold under agreements to repurchase with an original maturity greater than one year at December 31, 2013 and \$15.0 million in securities sold under agreements to repurchase with an original maturity greater than one year at December 31, 2012. Securities with an aggregate carrying value of \$19.0 million at December 31, 2012 were pledged to secure long-term securities sold under agreements to repurchase.

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

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

<i>(Dollars in thousands)</i>	2014	2015	2016	2017	2018	Thereafter	Total
FHLB advances	\$ —	—	—	—	5,000	—	5,000
Subordinated debentures	—	—	—	—	—	7,217	7,217
Total long-term debt	\$ —	—	—	—	5,000	7,217	12,217

NOTE 12: OTHER COMPREHENSIVE INCOME (LOSS)

Comprehensive income is defined as the change in equity from all transactions other than those with stockholders, and it includes net earnings and other comprehensive income (loss). Other comprehensive income (loss) for the years ended December 31, 2013, 2012, and 2011, is presented below.

<i>(In thousands)</i>	Pre-tax amount	Tax benefit (expense)	Net of tax amount
2013:			
Unrealized net holding loss on all other securities	\$ (14,761)	5,446	(9,315)
Reclassification adjustment for net gain on securities recognized in net earnings	(651)	240	(411)
Other comprehensive loss	\$ (15,412)	5,686	(9,726)
2012:			
Unrealized net holding gain on all other securities	\$ 2,188	(809)	1,379
Reclassification adjustment for net gain on securities recognized in net earnings	(679)	252	(427)
Other comprehensive income	\$ 1,509	(557)	952
2011:			
Unrealized net holding loss on other-than-temporarily impaired securities due to factors other than credit	\$ (130)	48	(82)
Unrealized net holding gain on all other securities	11,187	(4,128)	7,059
Reclassification adjustment for net gain on securities recognized in net earnings	(878)	324	(554)
Other comprehensive income	\$ 10,179	(3,756)	6,423

NOTE 13: INCOME TAXES

For the years ended December 31, 2013, 2012, and 2011 the components of income tax expense from continuing operations are presented below.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Current income tax expense:			
Federal	\$ 594	737	72
State	159	58	353
Total current income tax expense	753	795	425
Deferred income tax expense (benefit):			
Federal	1,330	472	(344)
State	207	152	(24)
Total deferred income tax expense (benefit)	1,537	624	(368)
Total income tax expense	\$ 2,290	1,419	57

Total income tax expense differs from the amounts computed by applying the statutory federal income tax rate of 34% to earnings before income taxes. A reconciliation of the differences for the years ended December 31, 2013, 2012, and 2011, is presented below.

<i>(Dollars in thousands)</i>	2013		2012		2011	
	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings
Earnings before income taxes	\$ 9,408		8,182		5,595	
Income taxes at statutory rate	3,199	34.0 %	2,782	34.0 %	1,902	34.0 %
Tax-exempt interest	(884)	(9.4)	(997)	(12.2)	(1028)	(18.4)
State income taxes, net of federal tax effect	242	2.6	179	2.2	183	3.3
Low-income housing credit	—	—	—	—	(891)	(15.9)
Bank owned life insurance	(145)	(1.5)	(151)	(1.8)	(157)	(2.8)
Change in valuation allowance	—	—	(505)	(6.2)	—	—
Other	(122)	(1.3)	111	1.4	48	0.9
Total income tax expense	\$ 2,290	24.4 %	1,419	17.4 %	57	1.1 %

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The Company had net deferred tax assets of \$5.4 million and \$1.2 million at December 31, 2013 and 2012, respectively, included in other assets on the consolidated balance sheets. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2013 and 2012 are presented below:

<i>(Dollars in thousands)</i>	December 31	
	2013	2012
Deferred tax assets:		
Allowance for loan losses	\$ 1,944	2,480
Other-than-temporary impairment on securities	—	464
Unrealized loss on securities	2,661	—
Write-downs on other real estate owned	282	489
Tax credit carry-forwards	1,137	932
Other	531	670
Total deferred tax assets	6,555	5,035
Deferred tax liabilities:		
Premises and equipment	90	11
Unrealized gain on securities	—	3,025
Originated mortgage servicing rights	867	563
Other	205	192
Total deferred tax liabilities	1,162	3,791
Net deferred tax asset	\$ 5,393	1,244

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion of the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projection for future taxable income over the periods which the temporary differences resulting in the remaining deferred tax assets are deductible, management believes it is more-likely-than-not that the Company will realize the benefits of these deductible differences at December 31, 2013. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

The change in the net deferred tax asset for the years ended December 31, 2013, 2012, and 2011, is presented below.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Net deferred tax asset:			
Balance, beginning of year	\$ 1,244	2,425	5,813
Deferred tax (expense) benefit related to continuing operations	(1,537)	(624)	368
Stockholders' equity, for accumulated other comprehensive loss (income)	5,686	(557)	(3,756)
Balance, end of year	\$ 5,393	1,244	2,425

ASC 740 defines the threshold for recognizing the benefits of tax return positions in the financial statements as “more-likely-than-not” to be sustained by the taxing authority. This section also provides guidance on the de-recognition, measurement, and classification of income tax uncertainties in interim periods. As of December 31, 2013, the Company had no unrecognized tax benefits related to federal or state income tax matters. The Company does not anticipate any material increase or decrease in unrecognized tax benefits during 2014 relative to any tax positions taken prior to December 31, 2013. As of December 31, 2013, the Company has accrued no interest and no penalties related to uncertain tax positions. It is the Company’s policy to recognize interest and penalties related to income tax matters in income tax expense.

The Company and its subsidiaries file consolidated U.S. federal and State of Alabama income tax returns. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service and the State of Alabama for the years ended December 31, 2010 through 2013.

NOTE 14: EMPLOYEE BENEFIT PLAN

The Company has a 401(k) Plan that covers substantially all employees. Participants may contribute up to 10% of eligible compensation subject to certain limits based on federal tax laws. The Company's matching contributions to the Plan are determined by the board of directors. Participants become 20% vested in their accounts after two years of service and 100% vested after six years of service. Company matching contributions to the Plan were \$115 thousand, \$115 thousand, and \$110 thousand for the years ended December 31, 2013, 2012, and 2011, respectively, and are included in salaries and benefits expense.

NOTE 15: DERIVATIVE INSTRUMENTS

Financial derivatives are reported at fair value in other assets or other liabilities on the accompanying Consolidated Balance Sheets. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings within other noninterest income on the accompanying Consolidated Statements of Earnings. From time to time, the Company may enter into interest rate swaps ("swaps") to facilitate customer transactions and meet their financing needs. Upon entering into these swaps, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2013 and December 31, 2012, the Company had no derivative contracts to assist in managing its own interest rate sensitivity.

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

A summary of the Company's interest rate swaps as of and for the years ended December 31, 2013 and 2012 is presented below.

		<u>Other Assets</u>	<u>Other Liabilities</u>	<u>Other noninterest income</u>
	<u>Notional</u>	<u>Estimated Fair Value</u>	<u>Estimated Fair Value</u>	<u>Gains (Losses)</u>
<i>(Dollars in thousands)</i>				
December 31, 2013:				
Pay fixed / receive variable	\$ 5,017	—	844	\$ 366
Pay variable / receive fixed	5,017	844	—	(366)
Total interest rate swap agreements	\$ 10,034	844	844	\$ —
December 31, 2012:				
Pay fixed / receive variable	\$ 5,367	—	1,210	\$ 115
Pay variable / receive fixed	5,367	1,210	—	(115)
Total interest rate swap agreements	\$ 10,734	1,210	1,210	\$ —

NOTE 16: COMMITMENTS AND CONTINGENT LIABILITIES

Credit-Related Financial Instruments

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

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

At December 31, 2013 and 2012, the following financial instruments were outstanding whose contract amount represents credit risk:

<i>(Dollars in thousands)</i>	December 31	
	2013	2012
Commitments to extend credit	\$ 38,870	\$ 48,525
Standby letters of credit	8,562	7,093

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds various assets as collateral, including accounts receivable, inventory, equipment, marketable securities, and property to support those commitments for which collateral is deemed necessary. The Company has recorded a liability for the estimated fair value of these standby letters of credit in the amount of \$78 thousand and \$74 thousand at December 31, 2013 and 2012, respectively.

Other Commitments

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2013, are as follows: 2014, \$287 thousand; 2015, \$174 thousand; 2016, \$111 thousand; 2017, \$45 thousand; 2018, none.

Contingent Liabilities

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

NOTE 17: FAIR VALUE

Fair Value Hierarchy

“Fair value” is defined by ASC 820, *Fair Value Measurements and Disclosures*, as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for an asset or liability at the measurement date. GAAP establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

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

Level 2—inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable for the asset or liability, either directly or indirectly.

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

Level changes in fair value measurements

Transfers between levels of the fair value hierarchy are generally recognized at the end of the reporting period. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company’s financial assets and liabilities generally is such that transfers in and out of any level are expected to be infrequent. For the years ended December 31, 2013, 2012, and 2011, there were no transfers between levels and no changes in valuation techniques for the Company’s financial assets and liabilities.

Assets and liabilities measured at fair value on a recurring basis

Securities available-for-sale

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

Interest rate swap agreements

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

AUDITED FINANCIAL STATEMENTS

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

<i>(Dollars in thousands)</i>	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2013:				
Securities available-for-sale:				
Agency obligations	\$ 44,522	—	44,522	—
Agency RMBS	162,358	—	162,358	—
State and political subdivisions	64,339	—	64,339	—
Total securities available-for-sale	271,219	—	271,219	—
Other assets ⁽¹⁾	844	—	844	—
Total assets at fair value	\$ 272,063	—	272,063	—
Other liabilities ⁽¹⁾	844	—	844	—
Total liabilities at fair value	\$ 844	—	844	—
December 31, 2012:				
Securities available-for-sale:				
Agency obligations	\$ 39,525	—	39,525	—
Agency RMBS	141,460	—	141,460	—
State and political subdivisions	77,838	—	77,838	—
Trust preferred securities	652	—	—	652
Total securities available-for-sale	259,475	—	258,823	652
Other assets ⁽¹⁾	1,210	—	1,210	—
Total assets at fair value	\$ 260,685	—	260,033	652
Other liabilities ⁽¹⁾	1,210	—	1,210	—
Total liabilities at fair value	\$ 1,210	—	1,210	—

⁽¹⁾Represents the fair value of interest rate swap agreements.

Assets and liabilities measured at fair value on a nonrecurring basis

Loans held for sale

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

Impaired Loans

Loans considered impaired under ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent.

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

for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

Other real estate owned

Other real estate owned, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at the lower of the loan's carrying amount or the fair value less costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less costs to sell. Fair values are generally based on third party appraisals of the property and are classified within Level 3 of the fair value hierarchy. The appraisals are sometimes further discounted based on management's historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts are typically significant unobservable inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, a loss is recognized in noninterest expense.

Mortgage servicing rights, net

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

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

<i>(Dollars in thousands)</i>	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2013:				
Loans held for sale	\$ 2,296	—	2,296	—
Loans, net ⁽¹⁾	5,305	—	—	5,305
Other real estate owned	3,884	—	—	3,884
Other assets ⁽²⁾	2,350	—	—	2,350
Total assets at fair value	\$ 13,835	—	2,296	11,539
December 31, 2012:				
Loans held for sale	\$ 2,887	—	2,887	—
Loans, net ⁽¹⁾	10,272	—	—	10,272
Other real estate owned	4,919	—	—	4,919
Other assets ⁽²⁾	1,526	—	—	1,526
Total assets at fair value	\$ 19,604	—	2,887	16,717

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

⁽²⁾Represents MSRs, net, carried at lower of cost or estimated fair value.

Quantitative Disclosures for Level 3 Fair Value Measurements

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements for trust preferred securities, included within available-for-sale securities, and recognized in the accompanying consolidated balance sheets using Level 3 inputs:

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Beginning balance	\$ 652	\$ 1,986	\$ 2,149
Total realized and unrealized gains and (losses):			
Included in net earnings	(87)	(6)	(338)
Included in other comprehensive income	41	146	175
Sales	(606)	(974)	—
Settlements	—	(500)	—
Ending balance	\$ —	\$ 652	\$ 1,986

The Company had no Level 3 assets measured at fair value on a recurring basis at December 31, 2013. For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2013, the significant unobservable inputs used in the fair value measurements are presented below.

<i>(Dollars in thousands)</i>	Carrying Amount	Valuation Technique	Significant Unobservable Input	Weighted Average of Input
Nonrecurring:				
Impaired loans	\$ 5,305	Appraisal	Appraisal discounts (%)	17.6%
Other real estate owned	3,884	Appraisal	Appraisal discounts (%)	14.0%
Mortgage servicing rights, net	2,350	Discounted cash flow	Prepayment speed or CPR (%)	7.5%
			Discount rate (%)	10.0%

Fair Value of Financial Instruments

ASC 825, *Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow analyses. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent markets and should not be considered representative of the liquidation value of the Company's financial instruments, but rather are a good-faith estimate of the fair value of financial instruments held by the Company. ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

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

Loans, net

Fair values for loans were calculated using discounted cash flows. The discount rates reflected current rates at which similar loans would be made for the same remaining maturities. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820 and generally produces a higher value than an exit-price approach. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

Loans held for sale

Fair values of loans held for sale are determined using quoted market secondary market prices for similar loans.

Time Deposits

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

Long-term debt

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

The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company's financial instruments at December 31, 2013 and 2012 are presented below. This table excludes financial instruments for which the carrying amount approximates fair value. Financial assets for which fair value approximates carrying value included cash and cash equivalents. Financial liabilities for which fair value approximates carrying value included noninterest-bearing demand, interest-bearing demand, and savings deposits due to these products having no stated maturity. In addition, financial liabilities for which fair value approximates carrying value included overnight borrowings such as federal funds purchased and securities sold under agreements to repurchase.

<i>(Dollars in thousands)</i>	Carrying amount	Estimated fair value	Fair Value Hierarchy		
			Level 1 inputs	Level 2 inputs	Level 3 Inputs
December 31, 2013:					
Financial Assets:					
Loans, net (1)	\$ 378,071	\$ 387,180	\$ —	\$ —	\$ 387,180
Loans held for sale	2,296	2,310	—	2,310	—
Financial Liabilities:					
Time Deposits	\$ 261,199	\$ 263,985	\$ —	\$ 263,985	\$ —
Long-term debt	12,217	12,569	—	12,569	—
December 31, 2012:					
Financial Assets:					
Loans, net (1)	\$ 391,470	\$ 399,533	\$ —	\$ —	\$ 399,533
Loans held for sale	2,887	2,952	—	2,952	—
Financial Liabilities:					
Time Deposits	\$ 263,195	\$ 267,636	\$ —	\$ 267,636	\$ —
Long-term debt	47,217	51,752	—	51,752	—

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

NOTE 18: RELATED PARTY TRANSACTIONS

A director of the Company is an officer in a construction company that the Company contracted with during 2012 and 2011 for the construction of a new branch facility in Valley, Alabama and the construction of a new drive-through banking facility and completion of other site work on the Bank’s main office campus in Auburn, Alabama. Total payments made to the construction company under the terms of the construction contracts were \$0.4 million, \$1.2 million and \$0.8 million for the years ended December 31, 2013, 2012, and 2011, respectively.

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

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

<i>(Dollars in thousands)</i>	Amount
Loans outstanding at December 31, 2012	\$ 5,405
New loans/advances	3,327
Repayments	(4,471)
Loans outstanding at December 31, 2013	\$ 4,261

During 2013 and 2012, certain executive officers and directors of the Company and the Bank, including companies with which they are affiliated, were deposit customers of the bank. Total deposits for these persons at December 31, 2013 and 2012 amounted to \$20.3 million and \$19.1 million, respectively.

NOTE 19: REGULATORY RESTRICTIONS AND CAPITAL RATIOS

The Company and the Bank are subject to various regulatory capital requirements and policies administered by federal and State of Alabama banking regulators. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a material effect on the consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company’s and Bank’s assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company’s and Bank’s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors, including anticipated capital needs. Supervisory assessments of capital adequacy may differ significantly from conclusions based solely upon risk-based capital ratios. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) Tier 1 leverage capital ratio, Tier 1 risk-based ratio and total risk-based ratio. Management believes, as of December 31, 2013, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2013, the Bank is “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized,” the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. Management has not received any notification from the Company’s or the Bank’s regulators that changes the Bank’s regulatory capital status.

The actual capital amounts and ratios and the aforementioned minimums as of December 31, 2013 and 2012 are presented below.

<i>(Dollars in thousands)</i>	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
At December 31, 2013:						
Tier 1 Leverage Capital						
Auburn National Bancorporation	\$ 76,037	10.10 %	\$ 30,119	4.00 %	N/A	N/A
AuburnBank	74,716	9.94	30,069	4.00	\$ 37,587	5.00 %
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	\$ 76,037	17.19 %	\$ 17,696	4.00 %	N/A	N/A
AuburnBank	74,716	16.84	17,742	4.00	\$ 26,614	6.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	\$ 81,385	18.40 %	\$ 35,392	8.00 %	N/A	N/A
AuburnBank	80,064	18.05	35,485	8.00	\$ 44,356	10.00 %
At December 31, 2012:						
Tier 1 Leverage Capital						
Auburn National Bancorporation	\$ 71,982	9.58 %	\$ 30,069	4.00 %	N/A	N/A
AuburnBank	71,277	9.50	30,011	4.00	\$ 37,514	5.00 %
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	\$ 71,982	16.20 %	\$ 17,768	4.00 %	N/A	N/A
AuburnBank	71,277	16.02	17,794	4.00	\$ 26,691	6.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	\$ 77,558	17.46 %	\$ 35,536	8.00 %	N/A	N/A
AuburnBank	76,853	17.28	35,588	8.00	\$ 44,485	10.00 %

Dividends paid by the Bank are a principal source of funds available to the Company for payment of dividends to its stockholders and for other needs. Applicable federal and state statutes and regulations impose restrictions on the amounts of dividends that may be declared by the subsidiary bank. State law and Federal Reserve policy restrict the Bank from declaring dividends in excess of the sum of the current year's earnings plus the retained net earnings from the preceding two years without prior approval. In addition to the formal statutes and regulations, regulatory authorities also consider the adequacy of the Bank's total capital in relation to its assets, deposits, and other such items. Capital adequacy considerations could further limit the availability of dividends from the Bank. At December 31, 2013, the Bank could have declared additional dividends of approximately \$9.8 million without prior approval of regulatory authorities. As a result of this limitation, approximately \$60.4 million of the Company's investment in the Bank was restricted from transfer in the form of dividends.

NOTE 20: AUBURN NATIONAL BANCORPORATION (PARENT COMPANY)

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

CONDENSED BALANCE SHEETS

<i>(Dollars in thousands)</i>	December 31	
	2013	2012
Assets:		
Cash and due from banks	\$ 2,408	1,316
Investment in bank subsidiary	70,164	76,547
Premises and equipment	—	158
Other assets	846	1,162
Total assets	\$ 73,418	79,183
Liabilities:		
Accrued expenses and other liabilities	\$ 1,716	1,817
Long-term debt	7,217	7,217
Total liabilities	8,933	9,034
Stockholders' equity	64,485	70,149
Total liabilities and stockholders' equity	\$ 73,418	79,183

CONDENSED STATEMENTS OF EARNINGS

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Income:			
Dividends from bank subsidiary	\$ 3,304	3,231	3,158
Noninterest income	1,284	288	385
Total income	4,588	3,519	3,543
Expense:			
Interest expense	236	236	236
Noninterest expense	302	318	485
Total expense	538	554	721
Earnings before income tax benefit and equity			
in undistributed earnings of bank subsidiary	4,050	2,965	2,822
Income tax expense (benefit)	275	(45)	(31)
Earnings before equity in undistributed earnings			
of bank subsidiary	3,775	3,010	2,853
Equity in undistributed earnings of bank subsidiary	3,343	3,753	2,685
Net earnings	\$ 7,118	6,763	5,538

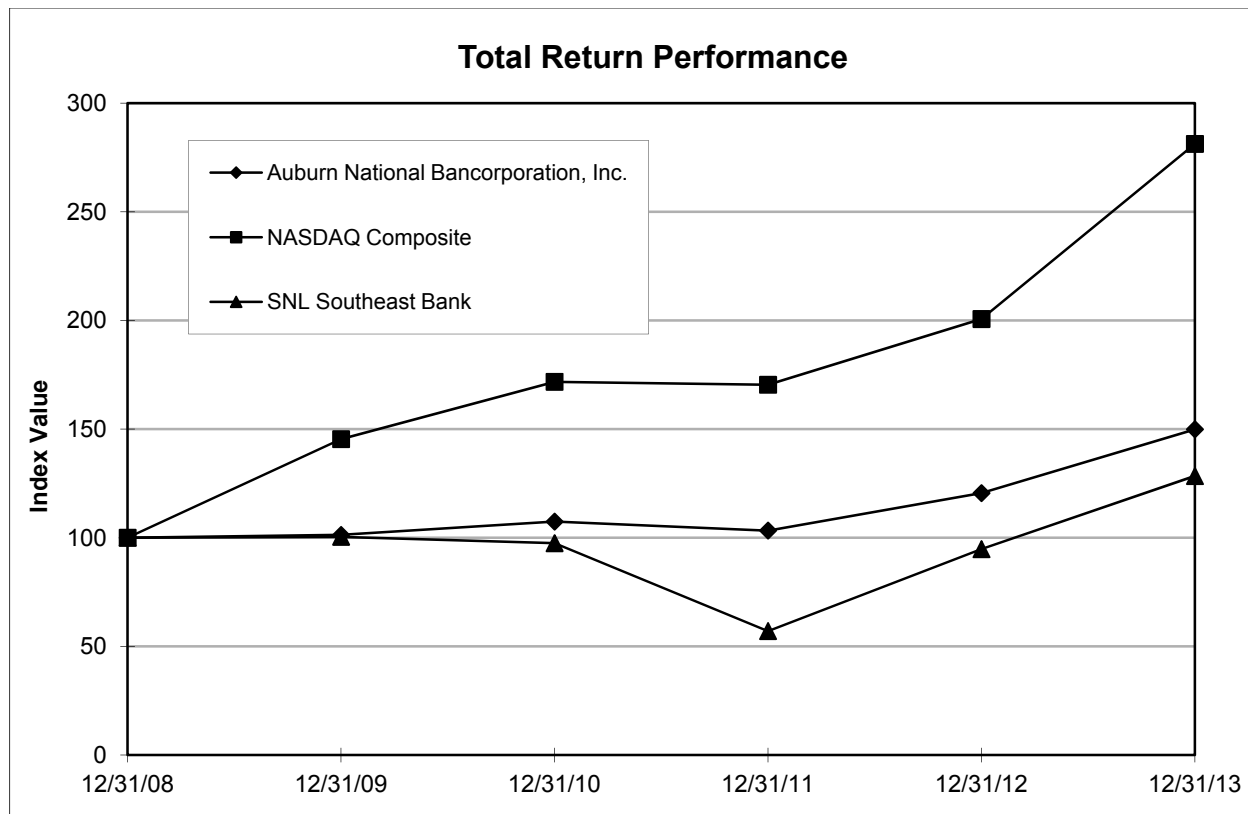
CONDENSED STATEMENTS OF CASH FLOWS

<i>(Dollars in thousands)</i>	Year ended December 31		
	2013	2012	2011
Cash flows from operating activities:			
Net earnings	\$ 7,118	6,763	5,538
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	28	29	80
Net gain on disposition of premises and equipment	(1,018)	—	—
Net decrease in other assets	316	16	22
Net decrease in other liabilities	(101)	(109)	(727)
Equity in undistributed earnings of bank subsidiary	(3,343)	(3,753)	(2,685)
Net cash provided by operating activities	3,000	2,946	2,228
Cash flows from investing activities:			
Purchases of premises and equipment	—	(17)	—
Proceeds from sale of premises and equipment to third party	1,148	—	—
Proceeds from sale of premises and equipment to bank subsidiary	—	—	4,450
Capital contribution to bank subsidiary	—	—	(3,200)
Net cash provided by (used in) investing activities	1,148	(17)	1,250
Cash flows from financing activities:			
Proceeds from sale of treasury stock	4	5	1
Dividends paid	(3,060)	(2,987)	(2,914)
Net cash used in financing activities	(3,056)	(2,982)	(2,913)
Net change in cash and cash equivalents	1,092	(53)	565
Cash and cash equivalents at beginning of period	1,316	1,369	804
Cash and cash equivalents at end of period	\$ 2,408	1,316	1,369

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STOCK PERFORMANCE GRAPH

The following performance graph compares the cumulative, total return on the Company’s Common Stock from December 31, 2008 to December 31, 2013, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a \$100 investment on December 31, 2008). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.



<i>Index</i>	<i>Period Ending</i>					
	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13
Auburn National Bancorporation, Inc.	100.00	101.30	107.43	103.28	120.53	149.88
NASDAQ Composite	100.00	145.36	171.74	170.38	200.63	281.22
SNL Southeast Bank	100.00	100.41	97.49	57.04	94.75	128.40

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Corporate Headquarters

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Independent Auditors

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

Shareholder Services

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

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

For frequently asked questions, visit the Transfer Agent's home page at www.rtco.com

Annual Meeting

Tuesday, May 13, 2014
3:00 p.m. (Central Time)
AuburnBank Center
132 N. Gay Street
Auburn, AL 36830

Investor Relations

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

Common Stock Listing

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

Dividend Reinvestment and Stock Purchase Plan

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

Direct Deposit of Dividends

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



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