

**T**OGETHER **E**VERYONE **A**CHIEVES **M**ORE



AUBURN NATIONAL BANCORPORATION, INC. **2014 ANNUAL REPORT**



**AUBURN BANK**



# T E A M

AUBURN NATIONAL BANCORPORATION, INC. **2014 ANNUAL REPORT**



AUBURNBANK

## To Our Shareholders and Friends

Through the years AuburnBank has maintained our history of success and our reputation for taking care of our customers. We still do and the phrase “May I help you?” means something to us. It also means our staff members, our officers, and our directors are involved and try to provide you with the best banking service and facilities possible.

Our efforts have allowed us to have a strong asset position, to continue growth in capital, and to increase deposits and loans in the communities we serve.

For 19 of the last 20 years, we have increased our dividends paid to shareholders, and in 2014, we paid cash dividends of \$0.86 per share.

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 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.

A handwritten signature in black ink, appearing to read "E.L. Spencer, Jr.", with a stylized, cursive script.

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



## Corporate Profile

2014 was another record earnings year for AuburnBank. Net earnings were \$7.4 million, or \$2.04 per share for the full year reflecting a 5% increase over 2013 earnings. Net interest income (tax equivalent) was \$22.7 million in 2014 compared to \$22.4 million in 2013. This increase was primarily due to growth in the balance sheet.

Total loans increased to \$403.0 million at December 31, 2014, an increase of \$19.6 million or 5% from December 31, 2013. Asset quality improved as continued efforts to reduce and resolve non-performing assets lowered our credit costs. At December 31, 2014, the bank had \$1.7 million in non-performing assets, a decrease of 80%, compared to \$8.1 million at December 31, 2013.

Equally important, the bank continues to successfully operate in a very competitive market by controlling expenses and providing quality customer service. The AuburnBank Team is comprised of team members who truly care about the quality of their work and assisting customers and each other with daily challenges. This year's annual report highlights two of our many behind-the-scenes departments, bookkeeping and loan operations. Both departments provide critical support for our entire bank. We would not enjoy the successes that we continue to achieve without their hard work and commitment to our bank. To our entire support team – Thank you for a job well done.

For eight of the past nine years (including 2014), the *American Banker* magazine has featured AuburnBank's parent company as one of the Top 200 Community Banks publicly traded under \$2.0 billion in total assets based on average return on equity for a three-year period. In 2014, AuburnBank was also selected by Keefe, Bruyette & Woods (KBW), an Investment Banking Firm, to their Bank Honor Roll of superior performers based on three criteria related to net income per share. Only 31 publicly traded banks in the U.S. over \$500 million in assets met the criteria required to receive this honor. All of these recognitions reflect the hard work and commitment of the entire AuburnBank team.

On behalf of the entire AuburnBank team, I would like to thank our customers and our shareholders for making 2014 such a successful year. We look forward to continuing to be your partner, your neighbor, and your friend in 2015.



Robert W. Dumas  
President and CEO  
AuburnBank



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**NINETEEN**  
OUT OF THE LAST  
**TWENTY**  
**YEARS**  
**DIVIDENDS**  
**TO SHAREHOLDERS**  
**HAVE INCREASED**  
*They never declined  
during the recession.*

As we reflect on the achievements for 2014, for AuburnBank, it is important to focus on our approach to meeting our goals. Through our service objective that emphasizes the TEAM (Together Everyone Achieves More) philosophy with each AuburnBank team member, we are able to produce greater results.

Instilling and rewarding behavior that incorporates core values such as integrity, accountability, commitment, innovation, individual respect and open communication for every employee is critical for our organization to fulfill its overall objectives.





The original founders of AuburnBank (Bank of Auburn) formed the first financial institution in Auburn based on quality services for citizens, businesses and the university. That legacy of founding principles continues to be prevalent in AuburnBank's mission today.

Efficient and effective utilization of resources are key objectives of every bank. AuburnBank is fortunate to have strong support in all departments within the bank. Featured in this year's report are two departments that provide critical support for AuburnBank – bookkeeping and loan operations. These two support teams assist both customers externally and staff internally with daily activities. These team members along with all employees take pride in their work by controlling expenses, maintaining strong compliance with policies and regulations, and providing quality customer service. These actions translate into strong financial results and happy customers.

Team effort also means providing cutting edge technology and online tools for many customers. Digital interaction with customers is critical to our current and future success. Our mobile technology offers fast and secure access to financial transactions and



**INCREASES  
IN EARNINGS  
PER SHARE  
FOR SIX  
CONSECUTIVE  
YEARS  
SINCE 2009**



Loan Operations Team

enables customers to deposit checks, pay bills, and transfer funds. All of these services also require superior operational support to ensure complete customer satisfaction.

In summary, the team approach values each employee's contribution and provides outstanding results. The team approach also encourages our employees to be involved in many worthy civic and charitable



Bookkeeping Team



Supporter of Food Bank of East Alabama

organizations, thus enhancing the quality of life for all citizens in our community. As we continue our journey of service in 2015, the entire AuburnBank team extends its sincere appreciation to all of our customers and shareholders for a successful 2014. We look forward to continuing to be your partner, your neighbor and your friend for many more years.



Supporter of Miracle League



Come visit us at our Corner Village Branch.



**THE ONLY BANK  
IN ALABAMA**  
RECOGNIZED BY BOTH  
KBW'S BANK HONOR ROLL  
**AND**  
AMERICAN BANKER'S TOP  
200 COMMUNITY BANKS

# Auburn National Bancorporation, Inc. and AuburnBank Board of Directors



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

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	Shannon O'Donnell Senior Vice President, Credit Administration/Chief Risk Officer	Kris Blackmon Vice President, Asset/Liability Manager Chief Investment Officer	Susan K. McChesney Vice President, IT/IS Assistant Chief Technology Officer	Barbara Wilcox Vice President, Security and BSA/OFAC Officer
Robert W. Dumas President & Chief Executive Officer	Jerry Siegel Senior Vice President, IT/IS Chief Technology Officer	S. Mark Bridges Vice President, Commercial/Consumer Loans	Marcia Otwell Vice President, Administration/Shareholder Relations	Karen Bence Assistant Vice President BSA/OFAC Officer
Jo Ann Hall Executive Vice President, Chief Operations Officer	C. Eddie Smith Senior Vice President, City President, Opelika Branch	Laura Carrington Vice President, Human Resource Officer	James R. Pack Vice President, Financial Reporting	Suzanne Gibson Assistant Vice President, Portfolio Management Officer
Terrell E. Bishop Senior Vice President, City President, Valley Branch	Robert Smith Senior Vice President, Chief Lending Officer	Kathy Crawford Vice President, Commercial/Consumer Loans	Cyndee Redmond Vice President, Operational Coordinator for Electronic Products and Services	Charlotte Lang Assistant Bank Secrecy Act Officer and Operations Officer
James E. Dulaney Senior Vice President, Business Development/Marketing	Bob R. Adkins Vice President, Commercial/Consumer Loans	Bruce Emfinger Vice President, Commercial/Consumer Loans	Jeff Stewart Vice President, Mortgage Loan Officer	Woody Odom Assistant Vice President, IT/IS
David Hedges Senior Vice President, Controller and CFO	Patty Allen Vice President, Commercial/Consumer Loans	Christy A. Fogle Vice President, Credit Administration	David Warren Vice President, Commercial/Consumer Loans	Sam S. Rainer Marketing Officer
W. Thomas Johnson Senior Vice President, Senior Lender	Scottie Arnold Vice President, Retail Internet/Operations Officer	Ginnie Y. Lunsford Vice President, Loan Operations		Rhonda Sanders Customer Service Officer/Assistant Patriot Act Officer
Marla Kickliter Senior Vice President, Compliance/Internal Auditor				Leigh Ann Thompson Branch Operations Administrative Officer

## Opelika Branch Advisory Board



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

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: Roy W. McClendon, Jr., Terrell E. Bishop, and H. David Ennis, Sr.  
Standing: John H. Hood, II, Frank P. Norman, and Claud E. (Skip) McCoy, Jr.

Terrell E. Bishop  
Senior Vice President,  
City President, Valley Branch

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

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,				
	2014	2013	2012	2011	2010
<b>Earnings</b>					
Net Interest Income	\$21,453	\$20,922	\$20,897	\$19,225	\$18,899
Provision for Loan Losses	50	400	3,815	2,450	3,580
Net Earnings	7,448	7,118	6,763	5,538	5,346
Per Share:					
Net Earnings	2.04	1.95	1.86	1.52	1.47
Cash Dividends	0.86	0.84	0.82	0.80	0.78
Book Value	20.80	17.70	19.26	17.96	15.47
Shares Issued	3,957,135	3,957,135	3,957,135	3,957,135	3,957,135
Weighted Average Shares Outstanding	3,643,328	3,643,003	3,642,831	3,642,735	3,642,851
<b>Financial Condition</b>					
Total Assets	789,231	751,343	759,833	776,218	763,829
Loans, net of unearned income	402,954	383,339	398,193	370,263	374,215
Investment Securities	267,603	271,219	259,475	299,582	315,220
Total Deposits	693,390	668,844	636,817	619,552	607,127
Long Term Debt	12,217	12,217	47,217	85,313	93,331
Stockholders' Equity	75,799	64,485	70,149	65,416	56,368
<b>Selected Ratios</b>					
Return on Average Total Assets	0.97%	0.94%	0.90%	0.72%	0.68%
Return on Average Total Equity	10.53%	10.33%	9.85%	9.10%	9.00%
Average Stockholders' Equity to Average Assets	9.17%	9.07%	9.09%	7.89%	7.61%
Allowance for Loan Losses as a % of Loans	1.20%	1.37%	1.69%	1.87%	2.05%
Loans to Total Deposits	58.11%	57.31%	62.53%	59.76%	61.64%



# AUBURN BANK

SINCE 1907

YOUR PARTNER, YOUR NEIGHBOR,  
YOUR FRIEND

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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) cyber attacks and data breaches that may compromise our systems or customers’ information; (xv) 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; (xvi) 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 (xvii) other factors and risks described under “Risk Factors” in the Company’s 2014 Annual Report on Form-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.

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 2014 Annual Report on Form 10-K and in any of our subsequent reports that we make with the 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 and regulations. The holding company structure also provides greater financial and operating flexibility than is presently permitted to the Bank.

The Bank has operated continuously since 1907 and currently conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank has been a member of the Federal Reserve System since April 1995. The Bank’s primary regulators are the Federal Reserve and the Alabama Superintendent of Banks (the “Alabama Superintendent”). The Bank has been a member of the Federal Home Loan Bank of Atlanta (the “FHLB”) since 1991.

### 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 14 locations in its primary service area. The Bank offers Visa® Checkcards, which are debit cards with the Visa logo that work like checks but can be used anywhere Visa is accepted, including ATMs. The Bank’s Visa Checkcards can be used internationally through the Cirrus® network. The Bank offers online banking and bill payment services through its Internet website, [www.auburnbank.com](http://www.auburnbank.com)

The Bank also has a commercial loan production office in Phenix City, Alabama.

### 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 “Lending Practices” 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, 2014 and 2013 and our results of operations for the years ended December 31, 2014, 2013, and 2012. 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 "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 in Opelika and Wal-Mart SuperCenter stores in both Auburn and Opelika. The Bank also operates a commercial loan production office in Phenix City, Alabama.

### Summary of Results of Operations

<i>(Dollars in thousands, except per share data)</i>	Year ended December 31		
	2014	2013	2012
Net interest income (a)	\$ 22,741	\$ 22,362	\$ 22,539
Less: tax-equivalent adjustment	1,288	1,440	1,642
Net interest income (GAAP)	21,453	20,922	20,897
Noninterest income	3,933	7,298	10,483
Total revenue	25,386	28,220	31,380
Provision for loan losses	50	400	3,815
Noninterest expense	15,104	18,412	19,383
Income tax expense	2,784	2,290	1,419
Net earnings	\$ 7,448	\$ 7,118	\$ 6,763
Basic and diluted earnings per share	\$ 2.04	\$ 1.95	\$ 1.86

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

### Financial Summary

The Company's net earnings were \$7.4 million, or \$2.04 per share, for the full year 2014, compared to \$7.1 million, or \$1.95 per share, for the full year 2013.

Net interest income (tax-equivalent) was \$22.7 million in 2014, compared to \$22.4 million in 2013. The increase was primarily due to a reduction in interest expense as the Company repaid higher-cost wholesale funding sources and lowered its deposit costs. The decrease in interest expense was partially offset by a decrease in interest income as yields on interest-earning assets also declined.

The provision for loan losses was \$0.1 million in 2014, compared to \$0.4 million in 2013. 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 \$0.5 million, or 0.12% of average loans, in 2014, compared to \$1.9 million, or 0.48% of average loans, in 2013.

Noninterest income was \$3.9 million in 2014, compared to \$7.3 million in 2013. The decrease in noninterest income was due to several factors, including a decrease in mortgage lending income of \$1.3 million as refinance activity declined, a decrease in net securities gains (losses) of \$1.2 million, and a decrease of \$1.0 million due to a gain on sale of premises and equipment realized in 2013 when the Company sold certain real property in downtown Auburn.

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Noninterest expense was \$15.1 million in 2014, compared to \$18.4 million in 2013. The decrease was primarily due to a decrease in prepayment penalties on long-term debt. The Company incurred no prepayment penalties on long-term debt in 2014, compared to \$3.0 million in 2013 when the Company repaid \$35.0 million long-term debt with a weighted average interest rate of 3.46%.

Income tax expense was \$2.8 million in 2014, compared to \$2.3 million in 2013. The Company's effective income tax rate was 27.21% in 2014, compared to 24.34% in 2013. The Company's effective income tax rate increased primarily due to a decrease in tax-exempt interest income on municipal securities. In addition, the impact of tax preference items, such as tax-exempt interest income, on the Company's effective tax rate is reduced as earnings before income taxes increases.

In 2014, the Company paid cash dividends of \$3.1 million, or \$0.86 per share. The Company remains "well capitalized" under current regulatory guidelines with a total risk-based capital ratio of 18.54%, a tier one risk-based capital ratio of 17.45%, and a tier one leverage capital ratio of 10.32% at December 31, 2014.

## **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, independent loan review process. The Company's loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the 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, 2014 and 2013, 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 2014 and 2013, the Company implemented certain refinements to its allowance for loan losses methodology in order to better capture the effects of the most recent economic cycle on the Company's loan loss experience. 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 using a rolling 8 quarter historical period (except for the commercial real estate loan segment, which used a 6 quarter historical period) and continued this methodology through March 31, 2014. Beginning with the quarter ended June 30, 2014, the Company calculated average losses for all loan segments using a rolling 20 quarter historical period and continued this methodology through December 31, 2014. Other than the changes discussed above, the Company has not made any material 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.

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## **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 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, 2014. 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					
	2014		2013		2012	
	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
<i>(Dollars in thousands)</i>						
Loans and loans held for sale	\$ 388,373	5.03%	\$ 390,288	5.28%	\$ 395,938	5.54%
Securities - taxable	207,655	2.23%	195,850	2.00%	199,794	1.94%
Securities - tax-exempt (a)	62,870	6.03%	67,797	6.25%	77,447	6.24%
Total securities	270,525	3.11%	263,647	3.09%	277,241	3.14%
Federal funds sold	56,110	0.19%	48,671	0.22%	27,466	0.20%
Interest bearing bank deposits	6,559	0.43%	5,634	0.75%	793	—
Total interest-earning assets	721,567	3.89%	708,240	4.08%	701,438	4.38%
Deposits:						
NOW	105,533	0.31%	101,034	0.32%	99,664	0.35%
Savings and money market	191,882	0.51%	171,413	0.52%	153,668	0.56%
Certificates of deposits less than \$100,000	101,561	1.15%	105,631	1.36%	108,726	1.63%
Certificates of deposits and other time deposits of \$100,000 or more	156,029	1.57%	155,781	1.77%	161,128	2.08%
Total interest-bearing deposits	555,005	0.89%	533,859	1.01%	523,186	1.21%
Short-term borrowings	3,814	0.50%	2,817	0.50%	2,970	0.54%
Long-term debt	12,217	3.42%	31,518	3.59%	49,115	3.73%
Total interest-bearing liabilities	571,036	0.94%	568,194	1.15%	575,271	1.42%
Net interest income and margin (a)	\$ 22,741	3.15%	\$ 22,362	3.16%	\$ 22,539	3.21%

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

## RESULTS OF OPERATIONS

### Net Interest Income and Margin

#### 2014 vs. 2013 comparison

Net interest income (tax-equivalent) was \$22.7 million in 2014, compared to \$22.4 million in 2013. The increase was primarily due to a reduction in interest expense as the Company repaid higher-cost wholesale funding sources and lowered its deposit costs. The decrease in interest expense was partially offset by a decrease in interest income as yields on interest-earning assets also declined. Although management continues to seek to increase earnings and net interest margin 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 improve net interest margin were offset by management's decision to carry higher levels of short-term interest earning assets (e.g. federal funds sold) during 2014.

The tax-equivalent yield on total interest-earning assets decreased by 19 basis points in 2014 from 2013 to 3.89%. The decrease was primarily due to 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.

The cost of total interest-bearing liabilities decreased 21 basis points in 2014 from 2013 to 0.94%. The net decrease was largely the result of the continued shift in our funding 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.

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.

#### 2013 vs. 2012 comparison

Net interest income (tax-equivalent) was \$22.4 million in 2013, compared to \$22.5 million in 2012. The decrease was primarily due to 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.

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 funding 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.

### 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 \$0.1 million, \$0.4 million, and \$3.8 million for the years ended December 31, 2014, 2013, and 2012, respectively.

These decreases were 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 \$0.5 million, or 0.12% of average loans, \$1.9 million, or 0.48% of average loans, and \$4.0 million, or 1.03% of average loans, for the years ended December 31, 2014, 2013, and 2012, respectively. In 2012, net charge-offs were impacted by a few individually significant charge-offs, including \$3.1 million related to three borrowing relationships.

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 1.20% at December 31, 2014 from 1.37% at December 31, 2013. 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, 2014. 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		
	2014	2013	2012
Service charges on deposit accounts	\$ 872	\$ 930	\$ 1,111
Mortgage lending	1,636	2,895	3,445
Bank-owned life insurance	501	427	445
Gain on sale of affordable housing investments	—	—	3,268
Gain on sale of premises and equipment	—	1,018	—
Securities (losses) gains, net	(530)	651	679
Other	1,454	1,377	1,535
<b>Total noninterest income</b>	<b>\$ 3,933</b>	<b>\$ 7,298</b>	<b>\$ 10,483</b>

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.

## Management's Discussion and Analysis

The Company evaluates MSR for impairment on a quarterly basis. 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 2014, 2013, and 2012.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2014	2013	2012
Origination income	\$ 1,163	\$ 2,030	\$ 3,430
Servicing fees, net	526	479	284
(Increase) decrease in MSR valuation allowance	(53)	386	(269)
Total mortgage lending income	\$ 1,636	\$ 2,895	\$ 3,445

### 2014 vs. 2013 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. In addition, mortgage lending income in 2013 was elevated due to decreases in the MSR valuation allowance.

The increase in income from bank-owned life insurance was primarily due to improved policy returns. During the fourth quarter of 2013, the Bank exchanged certain bank-owned life insurance policies with a cash surrender value of approximately \$5.9 million. These policies were exchanged for policies from two new carriers with better credit ratings and policy returns. The assets that support these policies are administered by the life insurance carriers and the income we receive from changes to the cash surrender value of the policies is dependent upon the returns the insurance carriers are able to earn on the underlying investments that support these policies. Earnings on these policies are generally not taxable.

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.

Net securities gains (losses) consist of realized gains and losses on the sale of securities and other-than-temporary impairment charges. Net securities losses were \$0.5 million in 2014, compared to net securities gains of \$0.7 million in 2013. Gross realized gains of \$0.5 million in 2014 were reduced by gross realized losses of \$0.7 million and \$0.3 million in other-than-temporary impairment charges. The Company recorded an other-than-temporary impairment charge of \$0.3 million in the first quarter of 2014 related to securities management intended to sell at March 31, 2014. Subsequent to March 31, 2014, the Company sold available-for-sale agency residential mortgage-backed securities ("RMBS") with a fair value of \$18.9 million and realized the expected loss of \$0.3 million. The Company incurred no additional other-than-temporary impairment charges in 2014. Gross realized gains of \$0.8 million in 2013 were reduced by gross realized losses of \$0.1 million. In December 2013, the Company sold all remaining trust preferred securities held by the Company for a net loss of \$0.1 million.

### 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.

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.

## Noninterest Expense

<i>(Dollars in thousands)</i>	Year ended December 31		
	2014	2013	2012
Salaries and benefits	\$ 8,943	\$ 8,788	\$ 8,691
Net occupancy and equipment	1,431	1,335	1,332
Professional fees	920	774	704
FDIC and other regulatory assessments	465	512	686
Other real estate owned, net	(450)	570	323
Prepayment penalties on long-term debt	—	3,028	3,720
Other	3,795	3,405	3,927
<b>Total noninterest expense</b>	<b>\$ 15,104</b>	<b>\$ 18,412</b>	<b>\$ 19,383</b>

### 2014 vs. 2013 comparison

The increase in salaries and benefits expense reflected routine annual increases.

The increase in net occupancy and equipment expense was primarily due to a decrease in rental income. During the fourth quarter of 2013, the Company sold an office building in downtown Auburn that was leased to third party tenants.

The increase in professional fees expense was primarily due to routine annual increases and an increase in consulting and advisory services related to various compliance and strategic initiatives.

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.

The decrease in OREO expense, net was primarily due to an increase in net gains realized on the sale of OREO of \$0.6 million and a decrease in OREO write-downs of \$0.3 million. The remaining improvement was due to a decrease in expenses related to maintenance costs and property taxes for these assets.

The Company incurred no prepayment penalties on long-term debt in 2014, compared to \$3.0 million in 2013 when the Company repaid \$35.0 million long-term debt with a weighted average interest rate of 3.46%.

### 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.

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

### 2014 vs. 2013 comparison

Income tax expense was \$2.8 million in 2014, compared to \$2.3 million in 2013. The Company's effective income tax rate was 27.21% in 2014, compared to 24.34% in 2013. The Company's effective income tax rate increased primarily due to a decrease in tax-exempt interest income on municipal securities. In addition, the impact of tax preference items, such as tax-exempt interest income, on the Company's effective tax rate is reduced as earnings before income taxes increases.

### 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. The Company's effective tax rate increased primarily because of a decrease in tax-exempt interest income on municipal securities in 2013 and 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 that were fully realized.

## BALANCE SHEET ANALYSIS

### Securities

Securities available-for-sale were \$267.6 million at December 31, 2014, a decrease of \$3.6 million, or 1.3%, compared to \$271.2 million as of December 31, 2013. This decline was primarily due to a decrease of \$14.7 million in the amortized cost basis of securities available-for-sale as proceeds from sales, calls, and maturities were not reinvested. This decrease was partially offset by changes in unrealized gains (losses) on securities available-for-sale of \$11.1 million, reflecting price gains as long-term interest rates fell during 2014. The average tax-equivalent yields earned on total securities were 3.11% in 2014 and 3.09% in 2013.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2014 according to contractual maturity. Actual maturities may differ from contractual maturities of residential mortgage-backed securities ("RMBS") because the mortgages underlying the securities may be called or prepaid with or without penalty.

	December 31, 2014				
	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Total Fair Value
<i>(Dollars in thousands)</i>					
Agency obligations	\$ —	30,947	14,869	14,433	60,249
Agency RMBS	—	—	14,523	120,520	135,043
State and political subdivisions	—	502	15,520	56,289	72,311
<b>Total available-for-sale</b>	<b>\$ —</b>	<b>31,449</b>	<b>44,912</b>	<b>191,242</b>	<b>267,603</b>
<b>Weighted average yield:</b>					
Agency obligations	—	1.53%	2.47%	2.79%	2.08%
Agency RMBS	—	—	2.14%	2.34%	2.32%
State and political subdivisions	—	4.30%	3.99%	3.77%	3.82%
<b>Total available-for-sale</b>	<b>—</b>	<b>1.57%</b>	<b>2.89%</b>	<b>2.79%</b>	<b>2.67%</b>

## Loans

	December 31				
<i>(In thousands)</i>	2014	2013	2012	2011	2010
Commercial and industrial	\$ 54,329	57,780	59,334	54,988	53,288
Construction and land development	37,298	36,479	37,631	39,814	47,850
Commercial real estate	192,006	174,920	183,611	162,435	166,241
Residential real estate	107,641	101,706	105,631	101,725	96,241
Consumer installment	12,335	12,893	12,219	11,454	10,676
Total loans	403,609	383,778	398,426	370,416	374,296
Less: unearned income	(655)	(439)	(233)	(153)	(81)
Loans, net of unearned income	\$ 402,954	383,339	398,193	370,263	374,215

Total loans, net of unearned income, were \$403.0 million at December 31, 2014, an increase of \$19.6 million, or 5%, from \$383.3 million at December 31, 2013. The increase was primarily attributable to growth in commercial real estate loans of \$17.1 million. Four loan categories represented the majority of the loan portfolio at December 31, 2014: commercial real estate mortgage loans (48%), residential real estate mortgage loans (27%), commercial and industrial loans (13%) and construction and land development loans (9%).

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately \$16.5 million, or 4%, and \$15.8 million, or 4% of total loans, net of unearned income at December 31, 2014 and 2013, respectively. For residential real estate mortgage loans with a consumer purpose, approximately \$1.9 million and \$1.2 million required interest-only payments at December 31, 2014 and 2013, 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 \$1.5 million and \$1.4 million as of December 31, 2014 and 2013, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company's normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures described in "Critical Accounting Policies."

The average yield earned on loans and loans held for sale was 5.03% in 2014 and 5.28% in 2013.

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 positions. 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 secured loan relationships in excess of approximately \$16.8 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$15.1 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, 2014, the Bank had no loan relationships exceeding this limit.

## Management's Discussion and Analysis

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, 2014 (and related balances at December 31, 2013).

<i>(In thousands)</i>	December 31	
	2014	2013
Lessors of 1-4 family residential properties	\$ 41,152	\$ 43,835
Multi-family residential properties	35,961	27,673
Shopping centers	30,016	29,953

### 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, 2014 and 2013, respectively, the allowance for loan losses was \$4.8 million and \$5.3 million, respectively, which management believed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under "Critical Accounting Policies".

A summary of the changes in the allowance for loan losses and certain asset quality ratios for each of the five years in the five year period ended December 31, 2014 is presented below.

<i>(Dollars in thousands)</i>	Year ended December 31				
	2014	2013	2012	2011	2010
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 5,268	6,723	6,919	7,676	6,495
Charge-offs:					
Commercial and industrial	(46)	(514)	(289)	(679)	(537)
Construction and land development	(235)	(39)	(231)	(1,758)	(1,487)
Commercial real estate	—	(262)	(3,184)	(422)	—
Residential real estate	(438)	(808)	(545)	(533)	(552)
Consumer installment	(89)	(397)	(85)	(21)	(111)
Total charge-offs	(808)	(2,020)	(4,334)	(3,413)	(2,687)
Recoveries:					
Commercial and industrial	71	48	54	34	63
Construction and land development	8	6	46	2	54
Commercial real estate	119	4	71	—	—
Residential real estate	112	88	134	155	151
Consumer installment	16	19	18	15	20
Total recoveries	326	165	323	206	288
Net charge-offs	(482)	(1,855)	(4,011)	(3,207)	(2,399)
Provision for loan losses	50	400	3,815	2,450	3,580
Ending balance	\$ 4,836	5,268	6,723	6,919	7,676
as a % of loans	1.20 %	1.37	1.69	1.87	2.05
as a % of nonperforming loans	433 %	124	64	67	65
Net charge-offs as a % of average loans	0.12 %	0.48	1.03	0.86	0.64

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 1.20% at December 31, 2014, compared to 1.37% at December 31, 2013. 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 \$0.5 million, or 0.12% of average loans, in 2014, compared to net charge-offs of \$1.9 million, or 0.48%, in 2013. With the exception of the construction and land development portfolio segment, all loan segments experienced a decline in net charge-offs in 2014.

At December 31, 2014 and 2013, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 433% and 124%, respectively. The increase was primarily due to a decrease in nonperforming loans of 74% in 2014.

At December 31, 2014 and 2013, the Company's recorded investment in loans considered impaired was \$3.3 million and \$5.6 million, respectively, with corresponding valuation allowances (included in the allowance for loan losses) of \$0.2 million and \$0.3 million at each respective date.

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, 2014 the Company had \$1.7 million in nonperforming assets compared to \$8.1 million at December 31, 2013. Nonperforming assets decreased during 2014 due to continued efforts by management to reduce and resolve problem assets.

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

<i>(Dollars in thousands)</i>	<b>December 31</b>				
	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Nonperforming assets:</b>					
Nonperforming (nonaccrual) loans	\$ 1,117	4,261	10,535	10,354	11,833
Other real estate owned	534	3,884	4,919	7,898	8,125
<b>Total nonperforming assets</b>	<b>\$ 1,651</b>	<b>8,145</b>	<b>15,454</b>	<b>18,252</b>	<b>19,958</b>
as a % of loans and other real estate owned	0.41 %	2.10	3.83	4.83	5.22
as a % of total assets	0.21 %	1.08	2.03	2.35	2.61
Nonperforming loans as a % of total loans	0.28 %	1.11	2.65	2.80	3.16
Accruing loans 90 days or more past due	\$ —	73	58	—	—

The table below provides information concerning the composition of nonaccrual loans at December 31, 2014 and 2013, respectively.

<i>(In thousands)</i>	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Nonaccrual loans:</b>		
Commercial and industrial	\$ 55	55
Construction and land development	605	1,582
Commercial real estate	263	1,456
Residential real estate	194	1,168
<b>Total nonaccrual loans / nonperforming loans</b>	<b>\$ 1,117</b>	<b>4,261</b>

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At December 31, 2014, the Company had \$1.1 million in loans on nonaccrual, compared to \$4.3 million at December 31, 2013. The decrease primarily related to the Company's three largest nonperforming loans at December 31, 2013. In 2014, the first loan's recorded investment was reduced by \$0.7 million due to principal repayments, the second loan, with a recorded investment of \$0.7 million at December 31, 2013, was paid off, and the third loan, with a recorded investment of \$0.8 million, was returned to accrual status.

## Management's Discussion and Analysis

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, 2014 and 2013, the Company had \$2.2 million and \$1.6 million, respectively, in accruing TDRs.

At December 31, 2014 there were no loans 90 days past due and still accruing interest compared to \$73,000 at December 31, 2013.

The table below provides information concerning the composition of OREO at December 31, 2014 and 2013, respectively.

<i>(In thousands)</i>	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Other real estate owned:</b>		
Commercial:		
Building	\$ —	1,772
Developed lots	252	1,260
Residential	282	852
Total other real estate owned	\$ 534	3,884

At December 31, 2014, the Company held \$0.5 million in OREO, which we acquired from borrowers, a decrease of \$3.4 million, or 86%, compared to December 31, 2013. The decrease was primarily due to increased sales activity and a reduction of inflows into OREO.

### 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 \$7.8 million, or 1.9% of total loans at December 31, 2014, compared to \$10.6 million, or 2.7% of total loans at December 31, 2013.

The table below provides information concerning the composition of potential problem loans at December 31, 2014 and 2013, respectively.

<i>(In thousands)</i>	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Potential problem loans:</b>		
Commercial and industrial	\$ 376	482
Construction and land development	556	1,101
Commercial real estate	884	1,683
Residential real estate	5,917	7,182
Consumer installment	114	146
Total potential problem loans	\$ 7,847	10,594

At December 31, 2014, approximately \$1.3 million or 17.1% of total potential problem loans were past due at least 30 but less than 90 days. At December 31, 2014, 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, 2014 and 2013, respectively.

<i>(In thousands)</i>	December 31	
	2014	2013
<b>Performing loans past due 30 to 89 days:</b>		
Commercial and industrial	\$ 168	167
Construction and land development	210	14
Commercial real estate	201	861
Residential real estate	2,231	1,343
Consumer installment	45	100
Total performing loans past due 30 to 89 days	\$ 2,855	2,485

### Deposits

<i>(In thousands)</i>	December 31	
	2014	2013
Noninterest bearing demand	\$ 130,160	125,740
NOW	111,243	99,406
Money market	163,237	147,116
Savings	39,624	35,383
Certificates of deposit under \$100,000	96,890	104,964
Certificates of deposit and other time deposits of \$100,000 or more	135,722	139,721
Brokered certificates of deposit	16,514	16,514
Total deposits	\$ 693,390	668,844

Total deposits were \$693.4 million and \$668.8 million at December 31, 2014 and 2013, respectively. The increase in total deposits of \$24.5 million and the change in deposit mix reflect customer preferences for short-term instruments in a low interest rate environment.

The average rates paid on total interest-bearing deposits were 0.89% in 2014 and 1.01% in 2013. Noninterest bearing deposits were 19% of total deposits at both December 31, 2014 and 2013.

### 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 \$38.0 million with none outstanding at December 31, 2014, compared to \$41.0 million with none outstanding at December 31, 2013. Securities sold under agreements to repurchase totaled \$4.7 million and \$3.4 million at December 31, 2014 and 2013, respectively.

The average rates paid on short-term borrowings were 0.50% in both 2014 and 2013. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the three-year period ended December 31, 2014 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 and subordinated debentures related to trust preferred securities. At both December 31, 2014 and 2013, the Bank had \$5.0 million in long-term FHLB advances outstanding and 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 3.42% in 2014 and 3.59% in 2013.

## CAPITAL ADEQUACY

The Company's consolidated stockholders' equity was \$75.8 million and \$64.5 million as of December 31, 2014 and 2013, respectively. The change from December 31, 2013 was primarily driven by net earnings of \$7.4 million and other comprehensive income due to the change in unrealized gains (losses) on securities available-for-sale, net-of-tax, of \$7.0 million, partially offset by cash dividends paid of \$3.1 million.

The Company's tier 1 leverage ratio was 10.32%, tier 1 risk-based capital ratio was 17.45% and total risk-based capital ratio was 18.54% at December 31, 2014. 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, 2014.

<u>Changes in Interest Rates</u>	<u>Net Interest Income % Variance</u>
200 basis points	1.31 %
(200) basis points	NM

NM=not meaningful



At December 31, 2014, 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, 2014.

<u>Changes in Interest Rates</u>	<u>EVE % Variance</u>
200 basis points	(11.46) %
(200) basis points	NM

NM=not meaningful

At December 31, 2014, 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, 2014 and 2013, the Company had no derivative contracts to assist in managing interest rate sensitivity.

## Liquidity Risk Management

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

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

The primary source of funding and the primary source of liquidity for the Company includes dividends received from the Bank, and secondarily proceeds from the issuance of common stock or other securities. Primary uses of funds for the Company include dividends paid to shareholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. The junior subordinated debentures are presented as long-term debt in the 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, 2014, the Bank had a remaining available line of credit with the FHLB totaling \$224.6 million. As of December 31, 2014, the Bank also had \$38.0 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, 2014, which by their terms had contractual maturity and termination dates subsequent to December 31, 2014:

	Payments due by period				
	Total	1 year or less	1 to 3 years	3 to 5 years	More than 5 years
<i>(Dollars in thousands)</i>					
<b>Contractual obligations:</b>					
Deposit maturities (1)	\$ 693,390	567,593	73,669	51,958	170
Long-term debt	12,217	—	—	5,000	7,217
Operating lease obligations	573	256	258	59	—
<b>Total</b>	<b>\$ 706,180</b>	<b>\$567,849</b>	<b>\$73,927</b>	<b>\$57,017</b>	<b>\$7,387</b>

(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, 2014, the Bank had outstanding standby letters of credit of \$8.3 million and unfunded loan commitments outstanding of \$49.8 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.

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### *Residential mortgage lending and servicing 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, 2014, the unpaid principal balance of the residential mortgage loans, which we have originated and sold, but retained the servicing rights was \$359.3 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.

In 2014, the Company was required to repurchase one loan with a principal balance of \$0.4 million as a result of the representation and warranty provisions contained in the Company's sale agreements with Fannie Mae. This loan was current as to principal and interest at the time of repurchase. The Company repurchased no residential mortgage loans in 2013 and one loan in 2012 with a principal balance of \$0.3 million that was current as to principal and interest at the time of repurchase. At December 31, 2014, the Company had one pending repurchase request related to representation and warranty provisions.

In 2013, Fannie Mae issued updated requirements for lender quality control programs which became effective January 1, 2014. As a result of these new requirements, the Company self-reported three loans to Fannie Mae for possible breaches related to representation and warranty provisions in 2014. At December 31, 2014, the three self-reported loans pending review by Fannie Mae had an aggregate principal balance of \$0.9 million and were current as to principal and interest. One of the three loans self-reported to Fannie Mae was for investment property, which has different underwriting guidelines than loans for primary residences. As part of its quality control review related to this one investment property loan, the Company identified certain underwriting deficiencies for nine additional investment property loans that were related to the same borrower. All ten loans were originated and sold to Fannie Mae. At December 31, 2014, the aggregate principal balance for all ten investment property loans was \$4.0 million and each loan was current as to principal and interest. The Company submitted a voluntary repurchase request to Fannie Mae in January 2015 for all ten investment property loans, which was approved. At December 31, 2014 and the date of repurchase in January 2015, the aggregate fair value of the ten investment property loans was greater than the repurchase price required by Fannie Mae. In response to the quality control review findings related to this one borrower, the Company has put additional controls in place for investment property loans originated for sale, including additional quality control reviews and management approvals. Furthermore, management has performed additional reviews of investment property loans originated for sale, including a review of the number of loans to one borrower, and does not believe there is any material exposure related to representation and warranty provisions for these loans. In 2014, investment property loans were only 7.0% of the total dollar volume of loans sold to Fannie Mae.

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, 2014, we believe that this exposure is not material due to the historical level of repurchase requests and loss trends, the results of our quality control reviews, and the fact that 99% 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 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*;
- ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*;
- ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*;
- ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*;
- ASU 2014-11, *Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*; and
- ASU 2014-14, *Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*.

Information about these pronouncements is described in more detail below.

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. Adoption of this ASU will not have a material impact on the consolidated financial statements of the Company.

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 material impact on the consolidated financial statements of the Company.

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ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*, changes the definition and reporting requirements for discontinued operations. Under the new guidance, an entity's disposal of a component or group of components must be reported in discontinued operations if the disposal is a strategic shift that has or will have a significant effect on the entity's operations and financial results. Major strategic shifts include disposals of a major geographic area or line of business. This guidance also requires new disclosures on discontinued operations. These changes are effective for the Company in the first quarter 2015 with prospective application. Early adoption is permitted for disposals that have not been previously reported. Adoption of this ASU will not have a material impact on the consolidated financial statements of the Company.

ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a comprehensive and converged standard on revenue recognition. The new guidance is intended to improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects consideration to which the entity expects to be entitled in exchange for those goods and services. This guidance also requires new qualitative and quantitative disclosures related to revenue from contracts with customers. These changes are effective for the Company in the first quarter 2017 with retrospective application to each prior reporting period or with the cumulative effect of initially applying this Update recognized at the date of initial application. Early adoption is not permitted. The Company is evaluating the impact this ASU will have on our consolidated financial statements.

ASU 2014-11, *Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*, changes current accounting and expands secured borrowing accounting for repurchase-to-maturity transactions and repurchase financings. This guidance requires new disclosures for certain repurchase agreements and similar transactions that identify which items are accounted for as secured borrowings and which items are accounted for as sales. These changes are effective for the Company in the first quarter 2015. The Company will be required to present changes in accounting for transactions outstanding as of January 1, 2015 as a cumulative-effect adjustment to retained earnings at the same date. Early adoption is not permitted. Adoption of this ASU will not have a material impact on the consolidated financial statements of the Company.

ASU No. 2014-14, *Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*, clarifies how creditors classify government-guaranteed mortgage loans, including FHA or VA guaranteed loans, upon foreclosure. Some creditors reclassify those loans to real estate consistent with other foreclosed loans that do not have guarantees; others reclassify the loans to other receivables. The amendments in this guidance require that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) The loan has a government guarantee that is not separable from the loan before foreclosure; (2) At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. These changes are effective for the Company in the first quarter of 2015 with prospective or modified retrospective application. Early adoption is permitted. Adoption of this ASU will not have a material impact on the consolidated financial statements of the Company.

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

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

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

	<b>2014</b>				<b>2013</b>			
	<b>Fourth Quarter</b>	<b>Third Quarter</b>	<b>Second Quarter</b>	<b>First Quarter</b>	<b>Fourth Quarter</b>	<b>Third Quarter</b>	<b>Second Quarter</b>	<b>First Quarter</b>
<i>(in thousands)</i>								
Net interest income (GAAP)	\$ 5,482	5,448	5,253	5,270	5,279	5,270	5,232	5,141
Tax-equivalent adjustment	331	321	312	324	342	351	365	382
Net interest income (Tax-equivalent) \$	5,813	5,769	5,565	5,594	5,621	5,621	5,597	5,523

	<b>Year ended December 31</b>				
	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<i>(In thousands)</i>					
Net interest income (GAAP)	\$ 21,453	20,922	20,897	19,225	18,899
Tax-equivalent adjustment	1,288	1,440	1,642	1,719	1,765
Net interest income (Tax-equivalent) \$	22,741	22,362	22,539	20,944	20,664

**Table 2 - Selected Financial Data**

	<b>Year ended December 31</b>				
<i>(Dollars in thousands, except per share amounts)</i>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Income statement</b>					
Tax-equivalent interest income (a)	\$ 28,105	28,898	30,709	32,425	35,237
Total interest expense	5,364	6,536	8,170	11,481	14,573
Tax equivalent net interest income (a)	22,741	22,362	22,539	20,944	20,664
Provision for loan losses	50	400	3,815	2,450	3,580
Total noninterest income	3,933	7,298	10,483	5,177	6,718
Total noninterest expense	15,104	18,412	19,383	16,357	15,893
Net earnings before income taxes and tax-equivalent adjustment	11,520	10,848	9,824	7,314	7,909
Tax-equivalent adjustment	1,288	1,440	1,642	1,719	1,765
Income tax expense	2,784	2,290	1,419	57	798
Net earnings	\$ 7,448	7,118	6,763	5,538	5,346
<b>Per share data:</b>					
Basic and diluted net earnings	\$ 2.04	1.95	1.86	1.52	1.47
Cash dividends declared	\$ 0.86	0.84	0.82	0.80	0.78
Weighted average shares outstanding					
Basic and diluted	3,643,278	3,643,003	3,642,831	3,642,735	3,642,851
Shares outstanding	3,643,328	3,643,118	3,642,903	3,642,738	3,642,718
Book value	\$ 20.80	17.70	19.26	17.96	15.47
Common stock price					
High	\$ 25.80	25.75	26.65	20.37	22.00
Low	22.10	20.80	18.23	18.52	16.86
Period-end	\$ 23.64	25.00	20.85	18.52	20.06
To earnings ratio	11.59x	12.89	11.21	12.10	13.74
To book value	114 %	141	108	103	130
<b>Performance ratios:</b>					
Return on average equity	10.53 %	10.33	9.85	9.10	9.00
Return on average assets	0.97 %	0.94	0.90	0.72	0.68
Dividend payout ratio	42.16 %	43.08	44.09	52.63	53.06
Average equity to average assets	9.17 %	9.07	9.09	7.89	7.61
<b>Asset Quality:</b>					
Allowance for loan losses as a % of:					
Loans	1.20 %	1.37	1.69	1.87	2.05
Nonperforming loans	433 %	124	64	67	65
Nonperforming assets as a % of:					
Loans and other real estate owned	0.41 %	2.10	3.83	4.83	5.22
Total assets	0.21 %	1.08	2.03	2.35	2.61
Nonperforming loans as % of loans	0.28 %	1.11	2.65	2.80	3.16
Net charge-offs as a % of average loans	0.12 %	0.48	1.03	0.86	0.64
<b>Capital Adequacy:</b>					
Tier 1 risk-based capital ratio	17.45 %	17.19	16.20	15.40	14.57
Total risk-based capital ratio	18.54 %	18.40	17.46	16.66	15.82
Tier 1 Leverage ratio	10.32 %	10.10	9.58	8.82	8.47
<b>Other financial data:</b>					
Net interest margin (a)	3.15 %	3.16	3.21	2.95	2.86
Effective income tax rate	27.21 %	24.34	17.34	1.02	12.99
Efficiency ratio (b)	56.62 %	62.08	58.70	62.62	58.04
<b>Selected period end balances:</b>					
Securities	\$ 267,603	271,219	259,475	299,582	315,220
Loans, net of unearned income	402,954	383,339	398,193	370,263	374,215
Allowance for loan losses	4,836	5,268	6,723	6,919	7,676
Total assets	789,231	751,343	759,833	776,218	763,829
Total deposits	693,390	668,844	636,817	619,552	607,127
Long-term debt	12,217	12,217	47,217	85,313	93,331
Total stockholders' equity	75,799	64,485	70,149	65,416	56,368

(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>	<b>2014</b>				<b>2013</b>			
	<b>Fourth</b>	<b>Third</b>	<b>Second</b>	<b>First</b>	<b>Fourth</b>	<b>Third</b>	<b>Second</b>	<b>First</b>
<b>Income statement</b>								
Tax-equivalent interest income (a)	\$ 7,117	7,100	6,929	6,959	7,108	7,207	7,226	7,357
Total interest expense	1,304	1,331	1,364	1,365	1,487	1,586	1,629	1,834
Tax equivalent net interest income (a)	5,813	5,769	5,565	5,594	5,621	5,621	5,597	5,523
Provision for loan losses	150	300	—	(400)	—	—	—	400
Total noninterest income	1,079	1,017	1,081	756	2,140	1,432	2,071	1,655
Total noninterest expense	3,780	3,584	3,792	3,948	5,188	4,274	4,724	4,226
Net earnings before income taxes and tax-equivalent adjustment	2,962	2,902	2,854	2,802	2,573	2,779	2,944	2,552
Tax-equivalent adjustment	331	321	312	324	342	351	365	382
Income tax expense	735	709	683	657	501	636	672	481
Net earnings	\$ 1,896	1,872	1,859	1,821	1,730	1,792	1,907	1,689
<b>Per share data:</b>								
Basic and diluted net earnings	\$ 0.52	0.51	0.51	0.50	0.47	0.49	0.52	0.46
Cash dividends declared	\$ 0.215	0.215	0.215	0.215	0.21	0.21	0.21	0.21
Weighted average shares outstanding								
Basic and diluted	3,643,328	3,643,328	3,643,295	3,643,161	3,643,110	3,643,028	3,642,955	3,642,918
Shares outstanding, at period end	3,643,328	3,643,328	3,643,328	3,643,173	3,643,118	3,643,058	3,642,993	3,642,928
Book value	\$ 20.80	20.09	19.84	18.74	17.70	18.06	17.90	19.27
Common stock price								
High	\$ 24.64	24.92	25.00	25.80	25.75	24.71	22.33	22.60
Low	22.10	23.17	22.90	23.20	23.93	22.00	21.54	20.80
Period-end	\$ 23.64	24.64	24.02	23.20	25.00	24.40	22.00	22.00
To earnings ratio	11.59 x	12.38	12.19	11.72	12.89	12.64	11.70	11.46
To book value	114 %	123	121	124	141	135	123	114
<b>Performance ratios:</b>								
Return on average equity	10.21 %	10.19	10.72	11.11	10.33	10.78	10.74	9.47
Return on average assets	0.98 %	0.97	0.96	0.96	0.92	0.95	1.00	0.87
Dividend payout ratio	41.35 %	42.16	42.16	43.00	44.68	42.86	40.38	45.65
Average equity to average assets	9.56 %	9.52	8.98	8.60	8.95	8.85	9.32	9.17
<b>Asset Quality:</b>								
Allowance for loan losses as a % of:								
Loans	1.20 %	1.20	1.23	1.25	1.37	1.56	1.65	1.73
Nonperforming loans	433 %	281	169	148	124	134	138	143
Nonperforming assets as a % of :								
Loans and other real estate owned	0.41 %	0.73	1.13	1.66	2.10	2.34	2.10	2.42
Total assets	0.21 %	0.37	0.57	0.81	1.08	1.21	1.08	1.24
Nonperforming loans as % of loans	0.28 %	0.43	0.73	0.84	1.11	1.16	1.19	1.22
Net charge-offs as % of average loans (c)	0.07 %	0.28	(0.02)	0.17	0.71	0.53	0.32	0.36
<b>Capital Adequacy:</b>								
Tier 1 risk-based capital ratio	17.45 %	17.43	17.45	17.55	17.19	17.29	16.45	16.32
Total risk-based capital ratio	18.54 %	18.50	18.53	18.64	18.40	18.55	17.70	17.57
Tier 1 Leverage ratio	10.32 %	10.26	10.07	10.03	10.10	9.96	9.76	9.42
<b>Other financial data:</b>								
Net interest margin (a)	3.14 %	3.16	3.09	3.20	3.20	3.19	3.16	3.09
Effective income tax rate	27.94 %	27.47	26.87	26.51	22.46	26.19	26.06	22.17
Efficiency ratio (b)	54.85 %	52.81	57.06	62.17	66.85	60.60	61.61	58.87
<b>Selected period end balances:</b>								
Securities	\$ 267,603	264,827	276,953	279,989	271,219	259,467	270,794	270,219
Loans, net of unearned income	402,954	394,602	385,826	377,350	383,339	380,705	390,726	390,570
Allowance for loan losses	4,836	4,754	4,728	4,711	5,268	5,946	6,457	6,769
Total assets	789,231	781,136	775,128	773,333	751,343	744,602	767,747	772,155
Total deposits	693,390	680,763	684,181	687,088	668,844	650,421	666,490	659,056
Long-term debt	12,217	12,217	12,217	12,217	12,217	22,217	27,217	37,217
Total stockholders' equity	75,799	73,193	72,291	68,284	64,485	65,807	65,211	70,217

(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								
	2014			2013			2012		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<i>(Dollars in thousands)</i>									
<b>Interest-earning assets:</b>									
Loans and loans held for sale (1)	\$ 388,373	\$ 19,551	5.03%	\$ 390,288	\$ 20,604	5.28%	\$ 395,938	\$ 21,943	5.54%
Securities - taxable	207,655	4,627	2.23%	195,850	3,912	2.00%	199,794	3,883	1.94%
Securities - tax-exempt (2)	62,870	3,790	6.03%	67,797	4,234	6.25%	77,447	4,829	6.24%
Total securities	270,525	8,417	3.11%	263,647	8,146	3.09%	277,241	8,712	3.14%
Federal funds sold	56,110	109	0.19%	48,671	106	0.22%	27,466	54	0.20%
Interest bearing bank deposits	6,559	28	0.43%	5,634	42	0.75%	793	—	—
Total interest-earning assets	721,567	28,105	3.89%	708,240	28,898	4.08%	701,438	30,709	4.38%
Cash and due from banks	12,915			13,694			14,125		
Other assets	36,490			37,836			39,742		
Total assets	<u>\$ 770,972</u>			<u>\$ 759,770</u>			<u>\$ 755,305</u>		
<b>Interest-bearing liabilities:</b>									
Deposits:									
NOW	\$ 105,533	331	0.31%	\$ 101,034	319	0.32%	\$ 99,664	349	0.35%
Savings and money market	191,882	982	0.51%	171,413	886	0.52%	153,668	859	0.56%
Certificates of deposits									
less than \$100,000	101,561	1,169	1.15%	105,631	1,437	1.36%	108,726	1,769	1.63%
Certificates of deposits and other time deposits of									
\$100,000 or more	156,029	2,445	1.57%	155,781	2,750	1.77%	161,128	3,347	2.08%
Total interest-bearing deposits	555,005	4,927	0.89%	533,859	5,392	1.01%	523,186	6,324	1.21%
Short-term borrowings	3,814	19	0.50%	2,817	14	0.50%	2,970	16	0.54%
Long-term debt	12,217	418	3.42%	31,518	1,130	3.59%	49,115	1,830	3.73%
Total interest-bearing liabilities	571,036	5,364	0.94%	568,194	6,536	1.15%	575,271	8,170	1.42%
Noninterest-bearing deposits	126,122			119,136			107,948		
Other liabilities	3,100			3,522			3,410		
Stockholders' equity	70,714			68,918			68,676		
Total liabilities and and stockholders' equity	<u>\$ 770,972</u>			<u>\$ 759,770</u>			<u>\$ 755,305</u>		
<b>Net interest income and margin</b>		<u>\$ 22,741</u>	<u>3.15%</u>		<u>\$ 22,362</u>	<u>3.16%</u>		<u>\$ 22,539</u>	<u>3.21%</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>	Years ended December 31, 2014 vs. 2013			Years ended December 31, 2013 vs. 2012		
	Net Change	Due to change in		Net Change	Due to change in	
		Rate (2)	Volume (2)		Rate (2)	Volume (2)
<b>Interest income:</b>						
Loans and loans held for sale	\$ (1,053)	(957)	(96)	\$ (1,339)	(1,041)	(298)
Securities - taxable	715	452	263	29	108	(79)
Securities - tax-exempt (1)	(444)	(147)	(297)	(595)	8	(603)
Total securities	271	305	(34)	(566)	116	(682)
Federal funds sold	3	(11)	14	52	6	46
Interest bearing bank deposits	(14)	(18)	4	42	6	36
Total interest income	\$ (793)	(681)	(112)	\$ (1,811)	(913)	(898)
<b>Interest expense:</b>						
Deposits:						
NOW	\$ 12	(2)	14	\$ (30)	(35)	5
Savings and money market	96	(9)	105	27	(65)	92
Certificates of deposits less than \$100,000	(268)	(221)	(47)	(332)	(290)	(42)
Certificates of deposits and other time deposits of \$100,000 or more	(305)	(309)	4	(597)	(503)	(94)
Total interest-bearing deposits	(465)	(541)	76	(932)	(893)	(39)
Short-term borrowings	5	0	5	(2)	(1)	(1)
Long-term debt	(712)	(52)	(660)	(700)	(69)	(631)
Total interest expense	(1,172)	(593)	(579)	(1,634)	(963)	(671)
Net interest income	\$ 379	(88)	467	\$ (177)	50	(227)

(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>	<b>December 31</b>				
	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Commercial and industrial	\$ 54,329	57,780	59,334	54,988	53,288
Construction and land development	37,298	36,479	37,631	39,814	47,850
Commercial real estate	192,006	174,920	183,611	162,435	166,241
Residential real estate	107,641	101,706	105,631	101,725	96,241
Consumer installment	12,335	12,893	12,219	11,454	10,676
Total loans	403,609	383,778	398,426	370,416	374,296
Less: unearned income	(655)	(439)	(233)	(153)	(81)
Loans, net of unearned income	402,954	383,339	398,193	370,263	374,215
Less: allowance for loan losses	(4,836)	(5,268)	(6,723)	(6,919)	(7,676)
Loans, net	\$ 398,118	378,071	391,470	363,344	366,539

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

		December 31, 2014						
		1 year	1 to 5	After 5		Adjustable	Fixed	
<i>(Dollars in thousands)</i>		or less	years	years	Total	Rate	Rate	Total
Commercial and industrial	\$	740	46,701	6,888	54,329	28,701	25,628	54,329
Construction and land development		1,342	29,866	6,090	37,298	17,129	20,169	37,298
Commercial real estate		2,027	92,536	97,443	192,006	16,231	175,775	192,006
Residential real estate		854	27,289	79,498	107,641	62,136	45,505	107,641
Consumer installment		142	10,923	1,270	12,335	3,254	9,081	12,335
Total loans	\$	5,105	207,315	191,189	403,609	127,451	276,158	403,609

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

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>				
	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 5,268	6,723	6,919	7,676	6,495
Charge-offs:					
Commercial and industrial	(46)	(514)	(289)	(679)	(537)
Construction and land development	(235)	(39)	(231)	(1,758)	(1,487)
Commercial real estate	—	(262)	(3,184)	(422)	—
Residential real estate	(438)	(808)	(545)	(533)	(552)
Consumer installment	(89)	(397)	(85)	(21)	(111)
Total charge-offs	(808)	(2,020)	(4,334)	(3,413)	(2,687)
Recoveries:					
Commercial and industrial	71	48	54	34	63
Construction and land development	8	6	46	2	54
Commercial real estate	119	4	71	—	—
Residential real estate	112	88	134	155	151
Consumer installment	16	19	18	15	20
Total recoveries	326	165	323	206	288
Net charge-offs	(482)	(1,855)	(4,011)	(3,207)	(2,399)
Provision for loan losses	50	400	3,815	2,450	3,580
Ending balance	\$ 4,836	5,268	6,723	6,919	7,676
as a % of loans	1.20 %	1.37	1.69	1.87	2.05
as a % of nonperforming loans	433 %	124	64	67	65
Net charge-offs as % of average loans	0.12 %	0.48	1.03	0.86	0.64
<b>Nonperforming assets:</b>					
Nonaccrual/nonperforming loans	\$ 1,117	4,261	10,535	10,354	11,833
Other real estate owned	534	3,884	4,919	7,898	8,125
Total nonperforming assets	\$ 1,651	8,145	15,454	18,252	19,958
as a % of loans and other real estate owned	0.41 %	2.10	3.83	4.83	5.22
as a % total assets	0.21 %	1.08	2.03	2.35	2.61
Nonperforming loans as a % of total loans	0.28 %	1.11	2.65	2.80	3.16
Accruing loans 90 days or more past due	\$ —	73	58	—	—

Table 9 - Allocation of Allowance for Loan Losses

<i>(Dollars in thousands)</i>	December 31									
	2014		2013		2012		2011		2010	
	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial and industrial	\$ 639	13.5	\$ 386	15.1	\$ 812	14.9	\$ 948	14.8	\$ 972	14.2
Construction and land development	974	9.2	366	9.5	1,545	9.4	1,470	10.7	2,223	12.8
Commercial real estate	1,928	47.6	3,186	45.6	3,137	46.1	3,009	43.9	2,893	44.4
Residential real estate	1,119	26.7	1,114	26.5	1,126	26.5	1,363	27.5	1,336	25.7
Consumer installment	176	3.1	216	3.4	103	3.1	129	3.1	141	2.9
Unallocated	—	—	—	—	—	—	—	—	111	—
Total allowance for loan losses	\$ 4,836		\$ 5,268		\$ 6,723		\$ 6,919		\$ 7,676	

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

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**Table 10 - CDs and Other Time Deposits of \$100,000 or More**

*(Dollars in thousands)*

**December 31, 2014**

<b>Maturity of:</b>	
3 months or less	\$ 19,063
Over 3 months through 6 months	12,684
Over 6 months through 12 months	41,998
Over 12 months	78,492
<u>Total CDs and other time deposits of \$100,000 or more (1)</u>	<u>\$ 152,237</u>

(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, 2014 in accordance with the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control – Integrated Framework (1992). Based on this assessment, management has concluded that such internal control over financial reporting was effective as of December 31, 2014.

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 a 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, 2014 and 2013, 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, 2014. 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, 2014 and 2013, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2014 in conformity with U.S. generally accepted accounting principles.

KPMG LLP

Birmingham, Alabama  
March 24, 2015

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

	<b>December 31</b>	
<i>(Dollars in thousands, except share data)</i>	<b>2014</b>	<b>2013</b>
<b>Assets:</b>		
Cash and due from banks	\$ 12,856	\$ 13,437
Federal funds sold	68,507	26,965
Interest bearing bank deposits	2,140	13,820
Cash and cash equivalents	83,503	54,222
Securities available-for-sale	267,603	271,219
Loans held for sale	1,974	2,296
Loans, net of unearned income	402,954	383,339
Allowance for loan losses	(4,836)	(5,268)
Loans, net	398,118	378,071
Premises and equipment, net	10,807	10,442
Bank-owned life insurance	18,004	17,503
Other real estate owned	534	3,884
Other assets	8,688	13,706
Total assets	\$ 789,231	\$ 751,343
<b>Liabilities:</b>		
Deposits:		
Noninterest-bearing	\$ 130,160	\$ 125,740
Interest-bearing	563,230	543,104
Total deposits	693,390	668,844
Federal funds purchased and securities sold under agreements to repurchase	4,681	3,363
Long-term debt	12,217	12,217
Accrued expenses and other liabilities	3,144	2,434
Total liabilities	713,432	686,858
<b>Stockholders' equity:</b>		
Preferred stock of \$.01 par value; authorized 200,000 shares; issued shares - none	—	—
Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,763	3,759
Retained earnings	76,193	71,879
Accumulated other comprehensive income (loss), net	2,443	(4,552)
Less treasury stock, at cost - 313,807 shares and 314,017 shares at December 31, 2014 and 2013, respectively	(6,639)	(6,640)
Total stockholders' equity	75,799	64,485
Total liabilities and stockholders' equity	\$ 789,231	\$ 751,343

*See accompanying notes to consolidated financial statements*

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

	Year ended December 31		
	2014	2013	2012
<i>(Dollars in thousands, except share and per share data)</i>			
<b>Interest income:</b>			
Loans, including fees	\$ 19,551	\$ 20,604	\$ 21,943
Securities:			
Taxable	4,627	3,912	3,883
Tax-exempt	2,502	2,794	3,187
Federal funds sold and interest bearing bank deposits	137	148	54
<b>Total interest income</b>	<b>26,817</b>	<b>27,458</b>	<b>29,067</b>
<b>Interest expense:</b>			
Deposits	4,927	5,392	6,324
Short-term borrowings	19	14	16
Long-term debt	418	1,130	1,830
<b>Total interest expense</b>	<b>5,364</b>	<b>6,536</b>	<b>8,170</b>
<b>Net interest income</b>	<b>21,453</b>	<b>20,922</b>	<b>20,897</b>
<b>Provision for loan losses</b>	<b>50</b>	<b>400</b>	<b>3,815</b>
<b>Net interest income after provision for loan losses</b>	<b>21,403</b>	<b>20,522</b>	<b>17,082</b>
<b>Noninterest income:</b>			
Service charges on deposit accounts	872	930	1,111
Mortgage lending	1,636	2,895	3,445
Bank-owned life insurance	501	427	445
Gain on sale of affordable housing investments	—	—	3,268
Gain on sale of premises and equipment	—	1,018	—
Other	1,454	1,377	1,535
Securities (losses) gains, net:			
Realized (losses) gains, net	(197)	651	809
Total other-than-temporary impairments	(333)	—	(130)
<b>Total securities (losses) gains, net</b>	<b>(530)</b>	<b>651</b>	<b>679</b>
<b>Total noninterest income</b>	<b>3,933</b>	<b>7,298</b>	<b>10,483</b>
<b>Noninterest expense:</b>			
Salaries and benefits	8,943	8,788	8,691
Net occupancy and equipment	1,431	1,335	1,332
Professional fees	920	774	704
FDIC and other regulatory assessments	465	512	686
Other real estate owned, net	(450)	570	323
Prepayment penalties on long-term debt	—	3,028	3,720
Other	3,795	3,405	3,927
<b>Total noninterest expense</b>	<b>15,104</b>	<b>18,412</b>	<b>19,383</b>
<b>Earnings before income taxes</b>	<b>10,232</b>	<b>9,408</b>	<b>8,182</b>
<b>Income tax expense</b>	<b>2,784</b>	<b>2,290</b>	<b>1,419</b>
<b>Net earnings</b>	<b>\$ 7,448</b>	<b>\$ 7,118</b>	<b>\$ 6,763</b>
<b>Net earnings per share:</b>			
Basic and diluted	\$ 2.04	\$ 1.95	\$ 1.86
<b>Weighted average shares outstanding:</b>			
Basic and diluted	3,643,278	3,643,003	3,642,831

*See accompanying notes to consolidated financial statements*

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

	<b>Year ended December 31</b>		
<i>(Dollars in thousands)</i>	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>Net earnings</b>	\$ 7,448	\$ 7,118	\$ 6,763
<b>Other comprehensive income (loss), net of tax:</b>			
Unrealized net holding gain (loss) on all other securities	6,660	(9,315)	1,379
Reclassification adjustment for net loss (gain) on securities recognized in net earnings	335	(411)	(427)
<b>Other comprehensive income (loss)</b>	6,995	(9,726)	952
<b>Comprehensive income (loss)</b>	\$ 14,443	\$ (2,608)	\$ 7,715

*See accompanying notes to consolidated financial statements*

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

	Common Stock		Additional paid-in capital	Retained earnings	Accumulated other comprehensive (loss) income	Treasury stock	Total
	Shares	Amount					
<i>(Dollars in thousands, except share data)</i>							
<b>Balance, December 31, 2011</b>	3,957,135	\$ 39	\$ 3,753	\$ 64,045	\$ 4,222	\$ (6,643)	\$ 65,416
Net earnings	—	—	—	6,763	—	—	6,763
Other comprehensive income	—	—	—	—	952	—	952
Cash dividends paid (\$0.82 per share)	—	—	—	(2,987)	—	—	(2,987)
Sale of treasury stock (165 shares)	—	—	3	—	—	2	5
<b>Balance, December 31, 2012</b>	3,957,135	\$ 39	\$ 3,756	\$ 67,821	\$ 5,174	\$ (6,641)	\$ 70,149
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
<b>Balance, December 31, 2013</b>	3,957,135	\$ 39	\$ 3,759	\$ 71,879	\$ (4,552)	\$ (6,640)	\$ 64,485
Net earnings	—	—	—	7,448	—	—	7,448
Other comprehensive income	—	—	—	—	6,995	—	6,995
Cash dividends paid (\$0.86 per share)	—	—	—	(3,134)	—	—	(3,134)
Sale of treasury stock (210 shares)	—	—	4	—	—	1	5
<b>Balance, December 31, 2014</b>	3,957,135	\$ 39	\$ 3,763	\$ 76,193	\$ 2,443	\$ (6,639)	\$ 75,799

*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		
	2014	2013	2012
<b>Cash flows from operating activities:</b>			
Net earnings	\$ 7,448	\$ 7,118	\$ 6,763
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Provision for loan losses	50	400	3,815
Depreciation and amortization	780	827	837
Premium amortization and discount accretion, net	1,548	1,956	2,992
Deferred tax expense	786	1,537	624
Net loss (gain) on securities available for sale	530	(651)	(679)
Net gain on sale of loans held for sale	(1,163)	(2,030)	(3,430)
Net (gain) loss on other real estate owned	(458)	477	245
Loss on prepayment of long-term debt	—	3,028	3,720
Loans originated for sale	(57,069)	(94,980)	(154,044)
Proceeds from sale of loans	58,089	96,779	156,967
Net gain on disposition of premises and equipment	—	(1,018)	—
Increase in cash surrender value of bank owned life insurance	(501)	(427)	(445)
Gain on sale of affordable housing partnership investments	—	—	(3,268)
Net (increase) decrease in other assets	(27)	1,232	1,131
Net increase (decrease) in accrued expenses and other liabilities	518	(523)	(166)
Net cash provided by operating activities	\$ 10,531	\$ 13,725	\$ 15,062
<b>Cash flows from investing activities:</b>			
Proceeds from sales of securities available-for-sale	37,132	40,251	57,650
Proceeds from maturities of securities available-for-sale	53,767	54,737	112,005
Purchase of securities available-for-sale	(78,278)	(123,449)	(130,352)
(Increase) decrease in loans, net	(20,572)	10,721	(33,456)
Net purchases of premises and equipment	(744)	(462)	(1,549)
Decrease in FHLB stock	235	1,153	2,067
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	4,480	2,836	4,249
Net cash (used in) provided by investing activities	\$ (3,980)	\$ (13,065)	\$ 19,113
<b>Cash flows from financing activities:</b>			
Net increase in noninterest-bearing deposits	4,420	7,726	11,738
Net increase in interest-bearing deposits	20,126	24,301	5,527
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	1,318	674	(116)
Repayments or retirement of long-term debt	—	(38,028)	(41,816)
Dividends paid	(3,134)	(3,060)	(2,987)
Net cash provided by (used in) financing activities	\$ 22,730	\$ (8,387)	\$ (27,654)
Net change in cash and cash equivalents	\$ 29,281	\$ (7,727)	\$ 6,521
Cash and cash equivalents at beginning of period	54,222	61,949	55,428
<b>Cash and cash equivalents at end of period</b>	<b>\$ 83,503</b>	<b>\$ 54,222</b>	<b>\$ 61,949</b>
<b>Supplemental disclosures of cash flow information:</b>			
Cash paid during the period for:			
Interest	\$ 5,406	\$ 6,761	\$ 8,535
Income taxes	1,413	758	1,224
<b>Supplemental disclosure of non-cash transactions:</b>			
Real estate acquired through foreclosure	\$ 475	\$ 2,278	\$ 1,515
<i>See accompanying notes to consolidated financial statements</i>			

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

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

**Nature of Business**

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

**Basis of Presentation**

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

**Use of Estimates**

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

**Reclassifications**

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

**Accounting Standards Adopted in 2014**

In the first quarter of 2014, the Company adopted new guidance related to the following Accounting Standards Update (“Update” or “ASU”):

- 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.*

Information about this pronouncement is described in more detail below.

ASU 2013-11 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. The changes were effective for the Company during the first quarter of 2014. Adoption of this ASU had no 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, 2014, 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 income, 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. The Company repurchased one residential mortgage loan in 2012 and another in 2014, with unpaid principal balances of \$0.3 million and \$0.4 million, respectively. Both loans were current as to principal and interest at the time of repurchase. Except for these two loans, during 2014, 2013, and 2012, 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



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

### **Allowance for Loan Losses**

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

### **Premises and Equipment**

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

### **Other Real Estate Owned**

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

### **Nonmarketable equity investments**

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

### **Transfers of Financial Assets**

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

## **Mortgage Servicing Rights**

The Company recognizes as assets the rights to service mortgage loans for others, known as MSR's. The Company determines the fair value of MSR's at the date the loan is transferred. An estimate of the Company's MSR's 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 MSR's under the amortization method. Under the amortization method, MSR's are amortized in proportion to, and over the period of, estimated net servicing income. The amortization of MSR's is analyzed monthly and is adjusted to reflect changes in prepayment speeds, as well as other factors. MSR's are evaluated for impairment based on the fair value of those assets. Impairment is determined by stratifying MSR's into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSR's exceeds fair value, a valuation allowance is established through a charge to earnings. The valuation allowance is adjusted as the fair value changes. MSR's are included in the other assets category in the accompanying consolidated balance sheets.

## **Derivative Instruments**

In accordance with 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 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, 2014. 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, 2014, 2013, and 2012, respectively, the Company had no such securities or other 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>	<b>Year ended December 31</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>Basic and diluted:</b>			
Net earnings	\$ 7,448	\$ 7,118	\$ 6,763
Weighted average common shares outstanding	3,643,278	3,643,003	3,642,831
Earnings per share	\$ 2.04	\$ 1.95	\$ 1.86

### 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, 2014, 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, 2014.

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

**NOTE 4: RESTRICTED CASH BALANCES**

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. As of December 31, 2014 and 2013, the Bank did not have a required reserve balance at the Federal Reserve Bank.

**NOTE 5: SECURITIES**

At December 31, 2014 and 2013, 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, 2014 and 2013, 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	
<b>December 31, 2014</b>									
Agency obligations (a)	\$	—	30,947	14,869	14,433	60,249	375	830	\$ 60,704
Agency RMBS (a)		—	—	14,523	120,520	135,043	1,597	616	134,062
State and political subdivisions		—	502	15,520	56,289	72,311	3,379	34	68,966
Total available-for-sale	\$	—	31,449	44,912	191,242	267,603	5,351	1,480	\$ 263,732
<b>December 31, 2013</b>									
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

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

Securities with aggregate fair values of \$132.2 million and \$120.5 million at December 31, 2014 and 2013, 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 \$1.6 and \$1.8 million at December 31, 2014 and 2013, 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, 2014 and 2013, 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
<b>December 31, 2014:</b>							
Agency obligations	\$	—	—	24,126	830	24,126	\$ 830
Agency RMBS		9,078	22	42,744	594	51,822	616
State and political subdivisions		4,257	34	—	—	4,257	34
Total	\$	13,335	56	66,870	1,424	80,205	\$ 1,480
<b>December 31, 2013:</b>							
Agency obligations	\$	35,932	3,181	8,590	1,376	44,522	\$ 4,557
Agency RMBS		109,774	4,394	7,683	339	117,457	4,733
State and political subdivisions		9,575	459	—	—	9,575	459
Total	\$	155,281	8,034	16,273	1,715	171,554	\$ 9,749

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For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. The Company 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, 2014, cost-method investments with an aggregate cost of \$1.6 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 2014, 2013, and 2012, 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		
	2014	2013	2012
Balance, beginning of period	\$ —	1,257	3,276
Additions:			
Subsequent credit impairments	—	—	130
Reductions:			
Securities sold	—	(757)	(2,149)
Securities fully written down and deemed worthless	—	(500)	—
Balance, end of period	\$ —	—	1,257

**Other-Than-Temporary Impairment**

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

<i>(Dollars in thousands)</i>	Year ended December 31		
	2014	2013	2012
<b>Other-than-temporary impairment charges (included in earnings):</b>			
Debt securities:			
Agency RMBS	\$ 333	—	—
Individual issuer trust preferred securities	\$ —	—	130
Total debt securities	\$ 333	—	130
Total other-than-temporary impairment charges (included in earnings)	\$ 333	—	130
<b>Other-than-temporary impairment on debt securities:</b>			
Recorded as part of gross realized losses:			
Credit-related	\$ —	—	130
Securities with intent to sell	333	—	—
Recorded directly to other comprehensive income for non-credit related impairment	—	—	—
Total other-than-temporary impairment on debt securities	\$ 333	—	130

**Realized Gains and Losses**

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

<i>(Dollars in thousands)</i>	Year ended December 31		
	2014	2013	2012
Gross realized gains	\$ 467	745	1,005
Gross realized losses	(664)	(94)	(196)
Other-than-temporary impairment charges	(333)	—	(130)
Realized gains, net	\$ (530)	651	679

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

<i>(In thousands)</i>	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Commercial and industrial	\$ 54,329	\$ 57,780
Construction and land development	37,298	36,479
Commercial real estate:		
Owner occupied	52,296	56,102
Other	139,710	118,818
Total commercial real estate	192,006	174,920
Residential real estate:		
Consumer mortgage	66,489	57,871
Investment property	41,152	43,835
Total residential real estate	107,641	101,706
Consumer installment	12,335	12,893
Total loans	403,609	383,778
Less: unearned income	(655)	(439)
Loans, net of unearned income	\$ 402,954	\$ 383,339

Loans secured by real estate were approximately 83.5% of the total loan portfolio at December 31, 2014. At December 31, 2014, 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, 2014 and 2013.

<i>(In thousands)</i>	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non- Accrual	Total Loans
<b>December 31, 2014:</b>						
Commercial and industrial	\$ 54,106	168	—	54,274	55	\$ 54,329
Construction and land development	36,483	210	—	36,693	605	37,298
Commercial real estate:						
Owner occupied	51,832	201	—	52,033	263	52,296
Other	139,710	—	—	139,710	—	139,710
Total commercial real estate	191,542	201	—	191,743	263	192,006
Residential real estate:						
Consumer mortgage	64,713	1,736	—	66,449	40	66,489
Investment property	40,503	495	—	40,998	154	41,152
Total residential real estate	105,216	2,231	—	107,447	194	107,641
Consumer installment	12,290	45	—	12,335	—	12,335
<b>Total</b>	<b>\$ 399,637</b>	<b>2,855</b>	<b>—</b>	<b>402,492</b>	<b>1,117</b>	<b>\$ 403,609</b>
<b>December 31, 2013:</b>						
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
<b>Total</b>	<b>\$ 376,959</b>	<b>2,485</b>	<b>73</b>	<b>379,517</b>	<b>4,261</b>	<b>\$ 383,778</b>

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 \$102 thousand, \$270 thousand, and \$511 thousand for the years ended December 31, 2014, 2013, and 2012, respectively.



## Allowance for Loan Losses

The allowance for loan losses as of and for the years ended December 31, 2014, 2013 and 2012, is presented below.

<i>(In thousands)</i>	Year ended December 31		
	2014	2013	2012
Beginning balance	\$ 5,268	\$ 6,723	\$ 6,919
Charged-off loans	(808)	(2,020)	(4,334)
Recovery of previously charged-off loans	326	165	323
Net charge-offs	(482)	(1,855)	(4,011)
Provision for loan losses	50	400	3,815
Ending balance	\$ 4,836	\$ 5,268	\$ 6,723

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, independent loan review process. The Company's loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the 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, 2014 and 2013, 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 2014 and 2013, the Company implemented certain refinements to its allowance for loan losses methodology in order to better capture the effects of the most recent economic cycle on the Company's loan loss experience. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 quarter historical period. If the Company continued to calculate average losses for all loan segments using a rolling 6 quarter historical period, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$1.1 million at June 30, 2013.

Beginning with the quarter ended June 30, 2013, the Company calculated average losses for all loan segments using a rolling 8 quarter historical period (except for the commercial real estate loan segment, which used a 6 quarter historical period) and continued this methodology through March 31, 2014. If the Company continued to calculate average losses for all loan segments other than commercial real estate using a rolling 8 quarter historical period and for the commercial real estate segment using a rolling 6 quarter historical period, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$1.0 million at June 30, 2014.

Beginning with the quarter ended June 30, 2014, the Company calculated average losses for all loan segments using a rolling 20 quarter historical period and continued this methodology through December 31, 2014. Other than the changes discussed above, the Company has not made any material 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, 2014, 2013, and 2012.

<i>(in thousands)</i>	Commercial and industrial	Construction and land Development	Commercial Real Estate	Residential Real Estate	Consumer Installment	Total
<b>Balance, December 31, 2011</b>	\$ 948	1,470	3,009	1,363	129	\$ 6,919
Charge-offs	(289)	(231)	(3,184)	(545)	(85)	(4,334)
Recoveries	54	46	71	134	18	323
Net charge-offs	(235)	(185)	(3,113)	(411)	(67)	(4,011)
Provision	99	260	3,241	174	41	3,815
<b>Balance, December 31, 2012</b>	\$ 812	1,545	3,137	1,126	103	\$ 6,723
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
<b>Balance, December 31, 2013</b>	\$ 386	366	3,186	1,114	216	\$ 5,268
Charge-offs	(46)	(235)	—	(438)	(89)	(808)
Recoveries	71	8	119	112	16	326
Net recoveries (charge-offs)	25	(227)	119	(326)	(73)	(482)
Provision	228	835	(1,377)	331	33	50
<b>Balance, December 31, 2014</b>	\$ 639	974	1,928	1,119	176	\$ 4,836

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, 2014 and 2013.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
<i>(In thousands)</i>						
<b>December 31, 2014:</b>						
Commercial and industrial	\$ 639	54,259	—	70	639	54,329
Construction and land development	974	36,693	—	605	974	37,298
Commercial real estate	1,734	190,306	194	1,700	1,928	192,006
Residential real estate	1,119	106,745	—	896	1,119	107,641
Consumer installment	176	12,335	—	—	176	12,335
Total	\$ 4,642	400,338	194	3,271	4,836	403,609
<b>December 31, 2013:</b>						
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

(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
<b>December 31, 2014</b>					
Commercial and industrial	\$ 49,550	4,348	376	55	\$ 54,329
Construction and land development	35,911	226	556	605	37,298
Commercial real estate:					
Owner occupied	49,900	1,905	228	263	52,296
Other	136,801	2,253	656	—	139,710
Total commercial real estate	186,701	4,158	884	263	192,006
Residential real estate:					
Consumer mortgage	59,646	1,912	4,891	40	66,489
Investment property	39,348	624	1,026	154	41,152
Total residential real estate	98,994	2,536	5,917	194	107,641
Consumer installment	12,200	21	114	—	12,335
<b>Total</b>	<b>\$ 383,356</b>	<b>11,289</b>	<b>7,847</b>	<b>1,117</b>	<b>\$ 403,609</b>
<b>December 31, 2013</b>					
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
<b>Total</b>	<b>\$ 361,218</b>	<b>7,705</b>	<b>10,594</b>	<b>4,261</b>	<b>\$ 383,778</b>

## 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).
- 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, 2014 and 2013.

<i>(In thousands)</i>	December 31, 2014			
	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
<b>With no allowance recorded:</b>				
Commercial and industrial	\$ 70	—	70	
Construction and land development	2,822	(2,217)	605	
Commercial real estate:				
Owner occupied	331	(68)	263	
Total commercial real estate	331	(68)	263	
Residential real estate:				
Consumer mortgages	934	(192)	742	
Investment property	180	(26)	154	
Total residential real estate	1,114	(218)	896	
Total	\$ 4,337	(2,503)	1,834	
<b>With allowance recorded:</b>				
Commercial real estate:				
Owner occupied	846	—	846	102
Other	591	—	591	92
Total commercial real estate	1,437	—	1,437	194
Total	\$ 1,437	—	1,437	\$ 194
<b>Total impaired loans</b>	<b>\$ 5,774</b>	<b>(2,503)</b>	<b>3,271</b>	<b>\$ 194</b>

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

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

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

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<i>(In thousands)</i>	December 31, 2013			
	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
<b>With no allowance recorded:</b>				
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	
<b>With allowance recorded:</b>				
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
<b>Total impaired loans</b>	<b>\$ 7,826</b>	<b>(2,261)</b>	<b>5,565</b>	<b>\$ 260</b>

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

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

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

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

<i>(In thousands)</i>	Year ended December 31, 2014		Year ended December 31, 2013		Year ended December 31, 2012	
	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized
<b>Impaired loans:</b>						
Commercial and industrial	\$ 98	7	\$ 188	9	\$ 194	13
Construction and land development	1,032	—	1,603	—	3,888	—
Commercial real estate:						
Owner occupied	1,308	40	1,972	51	2,449	64
Other	872	29	1,454	12	2,621	—
Total commercial real estate	2,180	69	3,426	63	5,070	64
Residential real estate:						
Consumer mortgages	731	43	786	—	861	—
Investment property	164	—	274	—	652	—
Total residential real estate	895	43	1,060	—	1,513	—
Total	\$ 4,205	119	\$ 6,277	72	\$ 10,665	77

## Troubled Debt Restructurings

Impaired loans also include troubled debt restructurings (“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. In determining the appropriate accrual status at the time of restructure, the Company evaluates whether a restructured loan has adequate collateral protection, among other factors.

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	
<b>December 31, 2014</b>				
Commercial and industrial	\$ 70	—	70	\$ —
Construction and land development	—	605	605	—
Commercial real estate:				
Owner occupied	846	263	1,109	102
Other	591	—	591	92
Total commercial real estate	1,437	263	1,700	194
Residential real estate:				
Consumer mortgages	742	—	742	—
Investment property	—	154	154	—
Total residential real estate	742	154	896	—
Total	\$ 2,249	1,022	3,271	\$ 194
<b>December 31, 2013</b>				
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

At December 31, 2014, 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
<b>December 31, 2014</b>			
Commercial real estate:			
Other	1	\$ 590	592
Total commercial real estate	1	590	592
Residential real estate:			
Consumer mortgages	1	712	712
Total residential real estate	1	712	712
Total	2	\$ 1,302	1,304
<b>December 31, 2013</b>			
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
<b>December 31, 2012</b>			
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

The majority of the loans modified in a TDR during the years ended December 31, 2014, 2013, and 2012, 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.



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)
<b>December 31, 2014</b>		
Commercial real estate:		
Owner occupied	1	\$ 272
Total commercial real estate	1	272
Total	1	\$ 272
<b>December 31, 2013</b>		
Construction and land development		
	1	\$ 1,197
Commercial real estate:		
Other	1	425
Total commercial real estate	1	425
Total	2	\$ 1,622
<b>December 31, 2012</b>		
Construction and land development		
	1	\$ 2,386
Total	1	\$ 2,386

(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, 2014 and 2013 is presented below.

<i>(Dollars in thousands)</i>	December 31	
	2014	2013
Land	\$ 5,916	5,288
Buildings and improvements	8,606	8,539
Furniture, fixtures, and equipment	3,214	3,164
Total premises and equipment	17,736	16,991
Less: accumulated depreciation	(6,929)	(6,549)
Premises and equipment, net	\$ 10,807	10,442

Depreciation expense was approximately \$380 thousand, \$418 thousand, and \$366 thousand for the years ended December 31, 2014, 2013 and 2012, 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 evaluates MSRs for impairment on a quarterly basis. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation allowance is established. The valuation allowance is adjusted as the fair value changes. Changes in the valuation allowance are recognized in earnings as a component of mortgage lending income.

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The following table details the changes in amortized MSR and the related valuation allowance for the years ended December 31, 2014, 2013, and 2012.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2014	2013	2012
Beginning balance	\$ 2,350	1,526	1,245
Additions, net	465	822	966
Amortization expense	(374)	(384)	(416)
Change in valuation allowance	(53)	386	(269)
Ending balance	\$ 2,388	2,350	1,526

**Valuation allowance included in MSRs, net:**

Beginning of period	\$ —	386	117
End of period	53	—	386

**Fair value of amortized MSRs:**

Beginning of period	\$ 3,452	1,526	1,245
End of period	3,238	3,452	1,526

Data and assumptions used in the fair value calculation related to MSRs at December 31, 2014 and 2013, respectively, are presented below.

<i>(Dollars in thousands)</i>	December 31	
	2014	2013
Unpaid principal balance	\$ 360,956	356,334
Weighted average prepayment speed (CPR)	9.6 %	7.5
Discount rate (annual percentage)	10.0 %	10.0
Weighted average coupon interest rate	3.9 %	3.9
Weighted average remaining maturity (months)	267	268
Weighted average servicing fee (basis points)	25.0	25.0

At December 31, 2014, the weighted average amortization period for MSRs was 6.6 years. Estimated amortization expense for each of the next five years is presented below.

<i>(Dollars in thousands)</i>	December 31, 2014
2015	\$ 353
2016	301
2017	265
2018	224
2019	194

## NOTE 9: DEPOSITS

At December 31, 2014, the scheduled maturities of certificates of deposit and other time deposits are presented below.

<i>(Dollars in thousands)</i>	<b>December 31, 2014</b>
2015	\$ 123,329
2016	40,783
2017	32,886
2018	19,225
2019	32,733
Thereafter	170
Total certificates of deposit and other time deposits	<u>\$ 249,126</u>

Additionally, at December 31, 2014 and 2013, approximately \$152.2 and \$156.2 million, respectively, of certificates of deposit and other time deposits were issued in denominations of \$100,000 or greater.

At December 31, 2014 and 2013, 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, 2014, 2013, and 2012, the composition of short-term borrowings is presented below.

<i>(Dollars in thousands)</i>	<u>2014</u>		<u>2013</u>		<u>2012</u>	
	<b>Amount</b>	<b>Weighted Avg. Rate</b>	<b>Amount</b>	<b>Weighted Avg. Rate</b>	<b>Amount</b>	<b>Weighted Avg. Rate</b>
<b>Federal funds purchased:</b>						
As of December 31	\$ —	—	\$ —	—	\$ —	—
Average during the year	16	0.90 %	43	0.92 %	225	0.96 %
Maximum outstanding at any month-end	—		2,376		1,925	
<b>Securities sold under agreements to repurchase:</b>						
As of December 31	\$ 4,681	0.50 %	\$ 3,363	0.50 %	\$ 2,689	0.50 %
Average during the year	3,797	0.50 %	2,774	0.50 %	2,746	0.50 %
Maximum outstanding at any month-end	4,681		3,363		3,174	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling \$38.0 million with none outstanding at December 31, 2014.

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 \$6.7 million and \$6.9 million at December 31, 2014 and 2013, respectively, were pledged to secure securities sold under agreements to repurchase.

**NOTE 11: LONG-TERM DEBT**

At December 31, 2014 and 2013, the composition of long-term debt is presented below.

<i>(Dollars in thousands)</i>	2014		2013	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
FHLB advances, due 2018	\$ 5,000	3.59%	\$ 5,000	3.59%
Subordinated debentures, due 2033	7,217	3.38	7,217	3.38
<b>Total long-term debt</b>	<b>\$ 12,217</b>	<b>3.47%</b>	<b>\$ 12,217</b>	<b>3.47%</b>

The Bank had \$5.0 million of FHLB advances with original maturities greater than one year at both December 31, 2014 and 2013. Certain qualifying residential mortgage loans with an aggregate carrying value of \$35.4 million at December 31, 2014, were pledged to secure long-term FHLB advances. Securities with an aggregate carrying value of \$1.0 million and certain qualifying residential mortgage loans with an aggregate carrying value of \$42.1 million at December 31, 2013, were pledged to secure long-term FHLB advances.

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>	2015	2016	2017	2018	2019	Thereafter	Total
FHLB advances	\$ —	—	—	5,000	—	—	5,000
Subordinated debentures	—	—	—	—	—	7,217	7,217
<b>Total long-term debt</b>	<b>\$ —</b>	<b>—</b>	<b>—</b>	<b>5,000</b>	<b>—</b>	<b>7,217</b>	<b>12,217</b>

**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, 2014, 2013, and 2012, is presented below.

<i>(In thousands)</i>	Pre-tax amount	Tax (expense) benefit	Net of tax amount
<b>2014:</b>			
Unrealized net holding gain on all other securities	\$ 10,553	(3,893)	6,660
Reclassification adjustment for net loss on securities recognized in net earnings	530	(195)	335
<b>Other comprehensive income</b>	<b>\$ 11,083</b>	<b>(4,088)</b>	<b>6,995</b>
<b>2013:</b>			
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)
<b>Other comprehensive loss</b>	<b>\$ (15,412)</b>	<b>5,686</b>	<b>(9,726)</b>
<b>2012:</b>			
Unrealized net holding gain on all other securities	\$ 2,188	(809)	1,379
Reclassification adjustment for net gain on securities recognized in net earnings	(679)	252	(427)
<b>Other comprehensive income</b>	<b>\$ 1,509</b>	<b>(557)</b>	<b>952</b>

## NOTE 13: INCOME TAXES

For the years ended December 31, 2014, 2013, and 2012 the components of income tax expense from continuing operations are presented below.

<i>(Dollars in thousands)</i>	Year ended December 31		
	2014	2013	2012
Current income tax expense:			
Federal	\$ 1,601	594	737
State	397	159	58
Total current income tax expense	1,998	753	795
Deferred income tax expense:			
Federal	731	1,330	472
State	55	207	152
Total deferred income tax expense	786	1,537	624
Total income tax expense	\$ 2,784	2,290	1,419

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, 2014, 2013, and 2012, is presented below.

<i>(Dollars in thousands)</i>	2014		2013		2012	
	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings
Earnings before income taxes	\$ 10,232		9,408		8,182	
Income taxes at statutory rate	3,479	34.0 %	3,199	34.0 %	2,782	34.0 %
Tax-exempt interest	(803)	(7.8)	(884)	(9.4)	(997)	(12.2)
State income taxes, net of federal tax effect	295	2.9	242	2.6	179	2.2
Bank owned life insurance	(170)	(1.7)	(145)	(1.5)	(151)	(1.8)
Change in valuation allowance	—	—	—	—	(505)	(6.2)
Other	(17)	(0.2)	(122)	(1.3)	111	1.4
Total income tax expense	\$ 2,784	27.2 %	2,290	24.4 %	1,419	17.4 %

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The Company had net deferred tax assets of \$0.5 million and \$5.4 million at December 31, 2014 and 2013, 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, 2014 and 2013 are presented below:

<i>(Dollars in thousands)</i>	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Deferred tax assets:</b>		
Allowance for loan losses	\$ 1,784	1,944
Unrealized loss on securities	—	2,661
Write-downs on other real estate owned	20	282
Tax credit carry-forwards	816	1,137
Other	480	531
Total deferred tax assets	3,100	6,555
<b>Deferred tax liabilities:</b>		
Premises and equipment	69	90
Unrealized gain on securities	1,427	—
Originated mortgage servicing rights	881	867
Other	204	205
Total deferred tax liabilities	2,581	1,162
Net deferred tax asset	\$ 519	5,393

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, 2014. 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, 2014, 2013, and 2012, is presented below.

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>Net deferred tax asset:</b>			
Balance, beginning of year	\$ 5,393	1,244	2,425
Deferred tax expense related to continuing operations	(786)	(1,537)	(624)
Stockholders' equity, for accumulated other comprehensive (income) loss	(4,088)	5,686	(557)
Balance, end of year	\$ 519	5,393	1,244

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, 2014, 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 2015 relative to any tax positions taken prior to December 31, 2014. As of December 31, 2014, 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, 2011 through 2014.

#### 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 \$122 thousand, \$115 thousand, and \$115 thousand for the years ended December 31, 2014, 2013, and 2012, 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, 2014 and December 31, 2013, 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, 2014 and 2013 is presented below.

		<u>Other Assets</u>	<u>Other Liabilities</u>	<u>Other noninterest income</u>
		<u>Estimated</u>	<u>Estimated</u>	<u>Gains</u>
	<u>Notional</u>	<u>Fair Value</u>	<u>Fair Value</u>	<u>(Losses)</u>
<i>(Dollars in thousands)</i>				
<b>December 31, 2014:</b>				
Pay fixed / receive variable	\$ 4,667	—	634	\$ 210
Pay variable / receive fixed	4,667	634	—	(210)
Total interest rate swap agreements	\$ 9,334	634	634	\$ —
<b>December 31, 2013:</b>				
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	\$ —

**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, 2014 and 2013, the following financial instruments were outstanding whose contract amount represents credit risk:

<i>(Dollars in thousands)</i>	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Commitments to extend credit	\$ 49,824	\$ 38,870
Standby letters of credit	8,337	8,562

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 \$72 thousand and \$78 thousand at December 31, 2014 and 2013, respectively.

***Other Commitments***

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2014, are as follows: 2015, \$256 thousand; 2016, \$178 thousand; 2017, \$100 thousand; 2018, \$30 thousand; 2019, \$29 thousand.

***Contingent Liabilities***

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



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## 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, 2014, 2013, and 2012, 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, 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, 2014 and 2013, 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)
<b>December 31, 2014:</b>				
Securities available-for-sale:				
Agency obligations	\$ 60,249	—	60,249	—
Agency RMBS	135,043	—	135,043	—
State and political subdivisions	72,311	—	72,311	—
Total securities available-for-sale	267,603	—	267,603	—
Other assets <sup>(1)</sup>	634	—	634	—
<b>Total assets at fair value</b>	<b>\$ 268,237</b>	<b>—</b>	<b>268,237</b>	<b>—</b>
Other liabilities <sup>(1)</sup>	634	—	634	—
<b>Total liabilities at fair value</b>	<b>\$ 634</b>	<b>—</b>	<b>634</b>	<b>—</b>
<b>December 31, 2013:</b>				
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 <sup>(1)</sup>	844	—	844	—
<b>Total assets at fair value</b>	<b>\$ 272,063</b>	<b>—</b>	<b>272,063</b>	<b>—</b>
Other liabilities <sup>(1)</sup>	844	—	844	—
<b>Total liabilities at fair value</b>	<b>\$ 844</b>	<b>—</b>	<b>844</b>	<b>—</b>

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

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

#### Loans held for sale

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

#### Impaired Loans

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

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2014 and 2013, respectively, by caption, on the accompanying consolidated balance sheets and by ASC 820 valuation hierarchy (as described above):

<i>(Dollars in thousands)</i>	<b>Amount</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b>December 31, 2014:</b>				
Loans held for sale	\$ 1,974	—	1,974	—
Loans, net <sup>(1)</sup>	3,077	—	—	3,077
Other real estate owned	534	—	—	534
Other assets <sup>(2)</sup>	2,388	—	—	2,388
Total assets at fair value	\$ 7,973	—	1,974	5,999
<b>December 31, 2013:</b>				
Loans held for sale	\$ 2,296	—	2,296	—
Loans, net <sup>(1)</sup>	5,305	—	—	5,305
Other real estate owned	3,884	—	—	3,884
Other assets <sup>(2)</sup>	2,350	—	—	2,350
Total assets at fair value	\$ 13,835	—	2,296	11,539

<sup>(1)</sup>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.

<sup>(2)</sup>Represents MSR's, 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		
	2014	2013	2012
Beginning balance	\$ —	\$ 652	\$ 1,986
Total realized and unrealized gains and (losses):			
Included in net earnings	—	(87)	(6)
Included in other comprehensive income	—	41	146
Sales	—	(606)	(974)
Settlements	—	—	(500)
Ending balance	\$ —	\$ —	\$ 652

The Company had no Level 3 assets measured at fair value on a recurring basis at December 31, 2014. For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2014, the significant unobservable inputs used in the fair value measurements are presented below.

<i>(Dollars in thousands)</i>	Carrying Amount	Valuation Technique	Significant Unobservable Input	Weighted Average of Input
<b>Nonrecurring:</b>				
Impaired loans	\$ 3,077	Appraisal	Appraisal discounts (%)	16.7%
Other real estate owned	534	Appraisal	Appraisal discounts (%)	26.0%
Mortgage servicing rights, net	2,388	Discounted cash flow	Prepayment speed or CPR (%)	9.6%
			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, 2014 and 2013 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
<b>December 31, 2014:</b>					
Financial Assets:					
Loans, net (1)	\$ 398,118	\$ 407,839	\$ —	\$ —	\$ 407,839
Loans held for sale	1,974	2,044	—	2,044	—
Financial Liabilities:					
Time Deposits	\$ 249,126	\$ 251,365	\$ —	\$ 251,365	\$ —
Long-term debt	12,217	12,558	—	12,558	—
<b>December 31, 2013:</b>					
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	—

(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 2014 to renovate a limited portion of the Bank’s operations center and to build out the leasehold improvements for the relocation of a bank branch. In 2012, the Company contracted with the same construction company for the construction of a new drive-through banking facility and completion of other site work on the Bank’s main office campus. Total payments made to the construction company under the terms of these contracts were \$0.1 million, \$0.4 million and \$1.2 million for the years ended December 31, 2014, 2013, and 2012, 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 for the year ended December 31, 2012.

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>	<b>Amount</b>
Loans outstanding at December 31, 2013	\$ 4,261
New loans/advances	1,685
Repayments	(1,105)
Loans outstanding at December 31, 2014	\$ 4,841

During 2014 and 2013, 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, 2014 and 2013 amounted to \$22.0 million and \$20.3 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, 2014, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2014, 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, 2014 and 2013 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
<b>At December 31, 2014:</b>						
Tier 1 Leverage Capital						
Auburn National Bancorporation	\$ 80,356	10.32 %	\$ 31,133	4.00 %	N/A	N/A
AuburnBank	78,968	10.16	31,099	4.00	\$ 38,873	5.00 %
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	\$ 80,356	17.45 %	\$ 18,419	4.00 %	N/A	N/A
AuburnBank	78,968	17.11	18,463	4.00	\$ 27,695	6.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	\$ 85,356	18.54 %	\$ 36,839	8.00 %	N/A	N/A
AuburnBank	83,968	18.19	36,927	8.00	\$ 46,158	10.00 %
<b>At December 31, 2013:</b>						
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 %

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, 2014, the Bank could have declared additional dividends of approximately \$11.4 million without prior approval of regulatory authorities. As a result of this limitation, approximately \$64.4 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>	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Assets:</b>		
Cash and due from banks	\$ 2,311	2,408
Investment in bank subsidiary	81,410	70,164
Other assets	846	846
<b>Total assets</b>	<b>\$ 84,567</b>	<b>73,418</b>
<b>Liabilities:</b>		
Accrued expenses and other liabilities	\$ 1,551	1,716
Long-term debt	7,217	7,217
<b>Total liabilities</b>	<b>8,768</b>	<b>8,933</b>
Stockholders' equity	75,799	64,485
<b>Total liabilities and stockholders' equity</b>	<b>\$ 84,567</b>	<b>73,418</b>

**CONDENSED STATEMENTS OF EARNINGS**

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>Income:</b>			
Dividends from bank subsidiary	\$ 3,377	3,304	3,231
Noninterest income	147	1,284	288
<b>Total income</b>	<b>3,524</b>	<b>4,588</b>	<b>3,519</b>
<b>Expense:</b>			
Interest expense	236	236	236
Noninterest expense	206	302	318
<b>Total expense</b>	<b>442</b>	<b>538</b>	<b>554</b>
Earnings before income tax (benefit) expense and equity in undistributed earnings of bank subsidiary	3,082	4,050	2,965
Income tax (benefit) expense	(114)	275	(45)
Earnings before equity in undistributed earnings of bank subsidiary	3,196	3,775	3,010
Equity in undistributed earnings of bank subsidiary	4,252	3,343	3,753
<b>Net earnings</b>	<b>\$ 7,448</b>	<b>7,118</b>	<b>6,763</b>



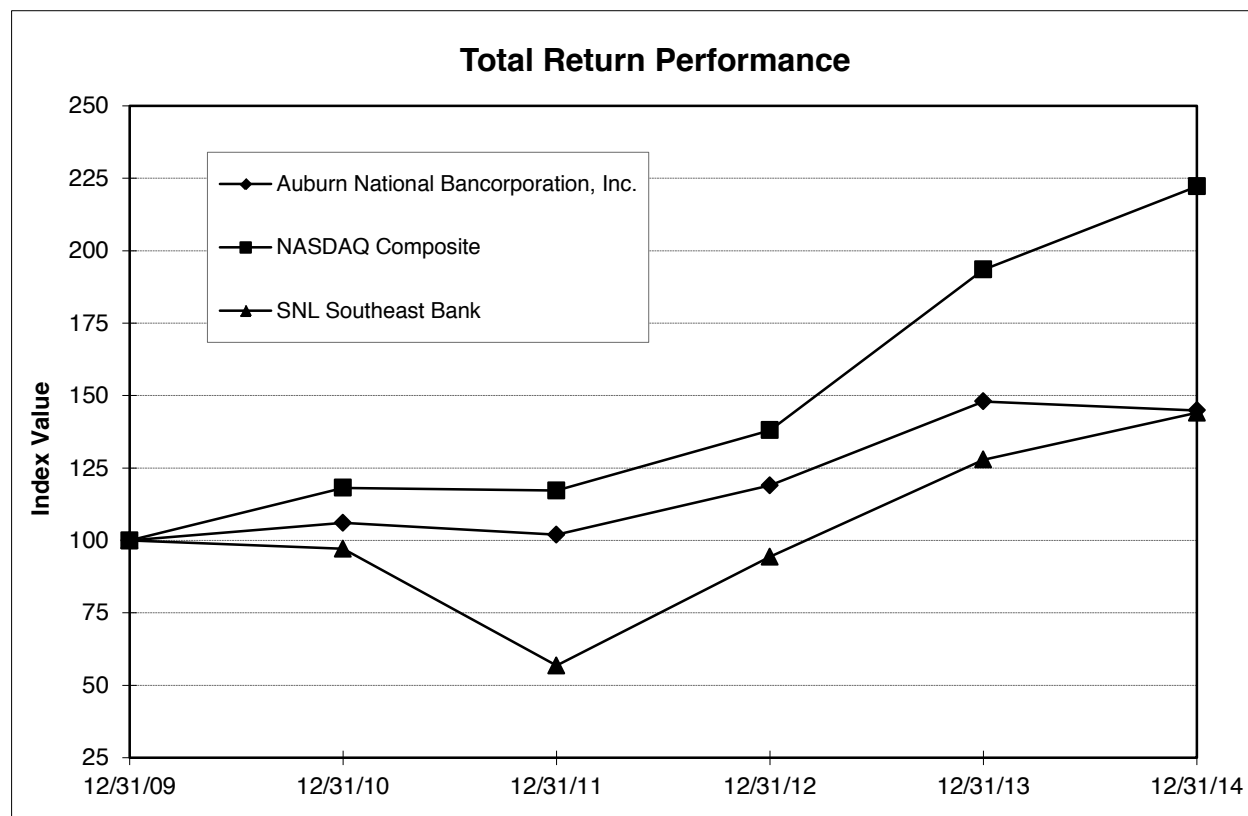
## CONDENSED STATEMENTS OF CASH FLOWS

<i>(Dollars in thousands)</i>	Year ended December 31		
	2014	2013	2012
<b>Cash flows from operating activities:</b>			
Net earnings	\$ 7,448	7,118	6,763
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	—	28	29
Net gain on disposition of premises and equipment	—	(1,018)	—
Net decrease in other assets	—	316	16
Net decrease in other liabilities	(159)	(97)	(104)
Equity in undistributed earnings of bank subsidiary	(4,252)	(3,343)	(3,753)
Net cash provided by operating activities	3,037	3,004	2,951
<b>Cash flows from investing activities:</b>			
Purchases of premises and equipment	—	—	(17)
Proceeds from sale of premises and equipment to third party	—	1,148	—
Net cash provided by (used in) investing activities	—	1,148	(17)
<b>Cash flows from financing activities:</b>			
Dividends paid	(3,134)	(3,060)	(2,987)
Net cash used in financing activities	(3,134)	(3,060)	(2,987)
Net change in cash and cash equivalents	(97)	1,092	(53)
Cash and cash equivalents at beginning of period	2,408	1,316	1,369
<b>Cash and cash equivalents at end of period</b>	<b>\$ 2,311</b>	<b>2,408</b>	<b>1,316</b>

# Stock Performance Graph

## STOCK PERFORMANCE GRAPH

The following performance graph compares the cumulative, total return on the Company's Common Stock from December 31, 2009 to December 31, 2014, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a \$100 investment on December 31, 2009). 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>					
	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14
Auburn National Bancorporation, Inc.	100.00	106.05	101.95	118.99	147.96	144.90
NASDAQ Composite	100.00	118.15	117.22	138.02	193.47	222.16
SNL Southeast Bank	100.00	97.10	56.81	94.37	127.88	144.03

# Corporate Information

## Corporate Headquarters

100 N. Gay Street  
P.O. Box 3110  
Auburn, AL 36831-3110  
Phone: 334-821-9200  
Fax: 334-887-2796  
[www.auburnbank.com](http://www.auburnbank.com)

## Independent Auditors

KPMG LLP  
Wachovia 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:

Computershare  
P. O. Box 30170  
College Station, TX 77842-3170  
Phone: 1-800-368-5948

For frequently asked questions, visit the Transfer Agent's home page at: [www.computershare.com](http://www.computershare.com)

## Annual Meeting

Tuesday, May 12, 2015  
3:00 p.m. (Central Time)  
AuburnBank Center  
132 N. Gay Street  
Auburn, AL 36830

## Investor Relations

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



**AUBURNBANK**

SINCE 1907  
YOUR PARTNER. YOUR NEIGHBOR.  
YOUR FRIEND



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YOUR FRIEND

[www.auburnbank.com](http://www.auburnbank.com)

Member FDIC