Stability. Commitment. Opportunity.

AUBURN NATIONAL BANCORPORATION, INC.

2018 ANNUAL REPORT

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AUBURNBANK

SINCE 1907
YOUR PARTNER, YOUR NEIGHBOR,
YOUR FRIEND

To Our Shareholders and Friends

I am pleased to report that 2018 was a record year for our Bank. Earnings of $8.8MM produced earnings per share of $2.42 and a ROA of 1.08%. Asset quality is strong and our reserves (capital) are solid.

Competition seems to be everywhere physically and on-line. Due to the commitment and loyalty of our shareholders, customers, directors, and staff, we continue to provide a stable return along with a consistent dividend.

I believe the opportunities for our Bank to meet the challenges of the future are linked directly to the quality service and caring culture of our entire Bank Team. We are blessed to live and work in vibrant communities with stable economies. We enjoy giving back so that many will experience the joyous feeling of happiness and hope.

We want to keep your money safe and help you achieve your financial goals. This is what our founders believed in and we are fortunate to continue this legacy.

Thank you for your continued support and encouragement as we look forward to remaining your bank of choice. On behalf of the entire AuburnBank Team, I hope you have a successful and productive 2019.

Robert W. Dumas

Robert W. Dumas
Chairman, President and CEO
AuburnBank and ANBC

Stability. Commitment. Opportunity.

Dumas chairmanship provides for a stable course, a solid commitment to the bank's core values and an opportunity for continued growth

Family photos, community honors and bank artifacts line shelves and hang on office walls, reflecting Bob Dumas' life with family, community and work. Following traditions since the bank was founded, the new Chairman and CEO of Auburn National Bancorp and AuburnBank takes the helm with a stellar banking background and service to the community, stretching back decades in a variety of leadership capacities.

Bob's family is Auburn through and through going back to 1940 when his father, the late William T. Dumas Jr. (Dub), caught a ride from a small town in Washington County to attend Auburn Polytechnic Institute, now Auburn University. After graduating in 1943, Dub married his hometown sweetheart, Tee, before serving in the Army during WWII with the Corp of Engineers in the Philippines.

When the war ended, Dub learned about the game of golf while he waited for their ship to return home. He developed a love for the sport and later taught his sons to play.

After returning to Auburn near the end of 1945, Dub began working on his master's degree, majoring in Agricultural Engineering. He was hired as a professor at Auburn University, while Tee worked at Bank of Auburn before Bob

was born at Lee County Hospital, now East Alabama Medical Center, in 1953.

Growing up on Heard Avenue in Auburn, Bob had a charmed childhood, beginning to play golf with his father when he was 5 years old. Bob and his brother, Trip, rode bikes to the Tiger Theater, to friends' homes and were active in sports. "We were living the dream that we might one day wear that orange and blue for Auburn," remembers Bob.

He played on the first golf team at Auburn High School and began to excel at golf. In both the ninth and tenth grades, he won the Alabama State High School Championship. That changed the direction of his sports life. He reluctantly gave up baseball, football and basketball to concentrate on golf. "I knew with golf I could get an education," he says. "Because of early successes with golf I felt like I would receive some college scholarship offers."

In fact, Auburn University offered him the first full golf scholarship. "I had several other opportunities," Bob adds, "but Auburn was in my heart." In his senior year in 1976, Auburn won the SEC Championship for Men's Golf for the very first time. Bob was also inducted into the Auburn Tiger Trail in 2006 because of his accomplishments on and off the course.

Bob began dating his wife, Martha Ann Butz, whose father was also an Auburn professor, in the ninth grade. They dated through high school and were students together at Auburn University.

They married in 1975 and Martha graduated in December from Auburn University in Laboratory Technology. She then pursued her master's degree in Physiology at Auburn University's School of Veterinary Medicine. She worked in the pathology lab at the Veterinary School while completing her master's and continued working at the Auburn University Veterinary School until the birth of their first child in 1981.

"For those of us that have known Bob and his family since we were young, it is no surprise that Bob has and continues to provide steady and visionary leadership for not only for AuburnBank, but also for all of our area communities and county. His valued leadership also reaches throughout our state and nation with service as a member of the Auburn University Board of Trustees and the Federal Reserve. Bob is truly a wonderful servant leader in so many capacities."

GRANT DAVIS

Secretary to the Auburn University Board of Trustees Emeritus

"We could not be more thankful that 35 years ago Bob followed in his Mother's footsteps and became an employee of AuburnBank. And today, it is our great privilege to have Bob as the leader of the AuburnBank Team. Through Bob's guidance and with his institutional knowledge, focus on customers, and compassion, we're confident AuburnBank will continue to be successful in the years to come."

ANNE M. MAY

Partner, Machen, McChesney & Chastain

"As a life-long friend of Bob Dumas, I read this somewhere and this is Bob. 'A man is what he is, not what men say he is. His reputation is what he is before men, but his character is what he is before God. His reputation can be damaged, but his character cannot. Reputation is for time on earth, character is for eternity.' Bob Dumas is a man with both a good reputation and character."

TREY JOHNSTON

Owner, J&M Bookstore

Bob graduated a year after Martha with a degree in Business Administration and a major in Finance. He had met many business friends through golf and decided to enter the banking business. Banking was appealing to Bob because of not only assisting businesses and individuals in achieving financial goals but also by being able to give back to the community through worthy organizations.

In 1976, Bob went to work at the Bank of East Alabama in Opelika. He quickly moved up the ranks, becoming the manager of a branch office.

Late in 1983, Chairman Ed Spencer at Auburn National Bank had heard good things about Bob and that his goal was to remain in his hometown. After a meeting with Mr. Spencer, Bob went to work at Auburn National Bank on the lending side in January 1984.

"I have done a little bit of everything in banking," Bob says. "Lending was my expertise. Auburn National Bank had a great reputation. They wanted to increase their lending portfolio. I am so thankful I joined the Auburn National Bank Team. Around 1995 when we went public, we changed our name to AuburnBank.

"It is a great place to work where we care about each other and each customer. AuburnBank has a long history and culture of being ingrained and involved in the community. That is very important to me.

"I still enjoy working with many customers today to assist them with their banking needs," Bob adds. "They have trust and confidence in us. We are conservative, have strong reserves and a strong reputation within the communities we serve."

Bob has been involved with the Auburn Chamber, United Way, Lee County Youth Development, Achievement Center, Food Bank of East Alabama, Boys and Girls Clubs and a number of other organizations. "They are great organizations that are giving back to the community and helping those not as fortunate or in a position to help themselves," he says. "All of these organizations are heartwarming and make you feel that you are doing the right thing and helping people who otherwise might not have been able to get assistance." He is also an active member of

"Bob Dumas is a humble man of the highest integrity. He is my lifelong friend, and I am very proud to say that he has had a profound impact on my life and the lives of many others. If he considers you a friend, you are indeed fortunate. Bob's primary motive in doing all he can do for Auburn is his very strong commitment to his family."

BILL HAM, JR.

Auburn Mayor 1998-2018

the Auburn United Methodist Church.

Recently, AuburnBank sponsored a home for Habitat for Humanity. They not only sponsored the home but gathered teams to work on the house. "That was very rewarding and heartwarming," says Bob, "to see a family receive a new home. Building the home was an entire bank effort, and our employees want to know when we are going to build another one. That's just what we do—give back to our communities."

He also enjoys assisting the Food Bank. "It is difficult to think about children and others not having access to food," he says. "We had a turkey

"There are certain community leaders we call on again and again because we can count on their guidance, support and wise counsel, and Bob Dumas is absolutely one of those. His graceful leadership and generosity of spirit are a gift to the Auburn community."

LOLLY STEINER

Executive Director, Auburn Chamber of Commerce

drive one year for the Food Bank. I was overwhelmed that some brought two or three turkeys to provide Thanksgiving dinner for those in need."

Along with the Auburn community, AuburnBank is also involved in Opelika, Phenix City, Chambers County and the Valley. "Our people are engaged in the communities where we have a bank," adds Bob. "I think that what makes us special is that we take pride in our civic involvement."

"We take ownership in giving back and being a good corporate citizen. It has been ingrained since Shel Toomer started the bank, and everyone who has been associated with the Bank."

Bob also serves on the board at the East Alabama Medical Center. "We are fortunate to have a great hospital," he says. "It has been rewarding to be associated with a well-run organization that doesn't turn away anybody for medical care."

In 2012, friends approached him about becoming a Trustee at Auburn University. He was nominated for the District 3 Lee County seat and was selected and confirmed by the Alabama Senate in 2012. "To be able to serve such a great institution and Lee County is truly humbling," Bob says.

Bob is also involved in many other organizations including the Federal Reserve Bank of Atlanta and the Alabama Bankers Association. "The relationships I have formed with my banking peers have been rewarding and special during my banking career."

Bob, Martha and their two daughters, Katie and Kristi, are all graduates of Auburn City Schools and Auburn University. Bob served on the Auburn City School Board for ten years where he enjoyed forming close friendships with fellow board members, administrators, teachers, coaches and parents during his tenure. "Being part of a highly successful school system was a very rewarding experience," Bob stated.

"Ed Spencer has been a mentor and friend, as well as a great role model for me both as an

"It has been my great fortune to work and serve alongside Bob for a number of decades and to know him personally. I have watched him during tender, trying and tumultuous moments and have seen character in action regardless of circumstance. Bob epitomizes Micah 6:8 — he loves kindness, does justice and walks humbly. Auburn is fortunate to have him as an impeccable community stalwart and I am blessed to have him as my cherished friend."

LAURA COOPER

Executive Director, Lee County Youth Development Center

"Bob is an outstanding person. He is a thoughtful, caring person who always puts others before himself."

WAYNE ALDERMAN

Dean and Professor Emeritus, Auburn University

individual and as a leader in the bank as chairman for 37 years," Bob adds. "I learned many things from him, not only about banking, but how to treat people. I look up to him as an example as to how it is supposed to be done both in business and banking and as a person.

"As far as AuburnBank is concerned, I believe that the one challenge going forward is staying on the cutting edge of banking services and products that customers need or desire. Protecting confidential information through cyber security defenses and protecting customer information is also critical. Your reputation is most important both as an individual and corporate citizen because of the trust factor. I think that is why we are still here, because people have confidence in us."

His parents were a tremendous influence on his life, and he is grateful for being raised in Auburn. "We were brought up to treat people the way you want to be treated. I think that is a great motto to live by, and try to help people when they need it. I love being here with family and friends. It is a great place to raise your family, to work and for cultural events, sporting events and education. I am just proud to be a part of it.

"Our AuburnBank board and employees are dedicated people," Bob adds. "I am excited about being part of a special team. The foundation and principles that Bank of Auburn was originally founded on are still applicable today and I look forward to continuing to provide the leadership and commitment that has made our bank an integral part of this community."

A New Home

Another example of AuburnBank's dedication to serving its customers is a building dedicated to the bank's wide range of mortgage products and services. The home for AuburnBank's team of local mortgage loan experts opened in 2018 and is convenient and centrally-located at 1967 East Samford Avenue in Auburn.

Auburn National Bancorporation, Inc. and AuburnBank Board of Directors

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

Terry W. Andrus
Retired, CEO, East Alabama Medical Center

C. Wayne Alderman
Secretary to ANBC
Dean and Professor Emeritus, College of Business, Auburn University

J. Tutt Barrett
Attorney, Dean and Barrett

Robert W. Dumas
Chairman, President & CEO, AuburnBank

William F. Ham, Jr.
Owner, Varsity Enterprises

David E. Housel
Director of Athletics Emeritus, Auburn University

Anne M. May
Retired Partner, Machen McChesney, CPAs

Amy B. Murphy
Director of Graduate Programs, Accounting, Auburn University

E.L. Spencer, Jr.
Chairman Emeritus

Edward Lee Spencer, III
Investor

Dr. Patricia Wade
Physician, Pinnacle Cardiovascular Associates

AuburnBank Officers

Robert W. Dumas
Chairman, President & Chief Executive Officer

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

S. Mark Bridges
Senior Vice President, Commercial/Consumer Loans

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

David Hedges
Executive Vice President, Chief Financial Officer

W. Thomas Johnson
Senior Vice President, Senior Lender

Marla Kickliter
Senior Vice President, Compliance/Internal Auditor

Mike King
Senior Vice President, Mortgage Lending Division

Shannon O'Donnell
Senior Vice President, Credit Administration/Chief Risk Officer

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

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

Robert Smith
Senior Vice President, Chief Lending Officer

James Walker
Senior Vice President, Chief Accounting Officer

Bob R. Adkins
Vice President, Commercial/Consumer Loans

Patty Allen
Vice President, Commercial/Consumer Loans

Scottie Arnold
Vice President, Administration Deposit Products/Services

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

Laura Carrington
Vice President, Human Resource Officer

Bruce Emfinger
Vice President, Commercial/Consumer Loans

Jeff Stanfield
Vice President, Commercial/Consumer Loans

James Salter
Vice President, Commercial/Consumer Loans

Christy A. Fogle
Vice President, Credit Administration

Pam Fuller
Vice President, Operations

Ginnie Y. Lunsford
Vice President, Loan Operations

Marcia Otwell
Vice President, Administration/Shareholder Relations

James R. Pack
Vice President, Financial Reporting

Cyndee Redmond
Vice President, Business Systems Analysis

David Warren
Vice President, Commercial/Consumer Loans

Karen Bence
Assistant Vice President Security, BSA/OFAC Officer

Hope Woods
Assistant BSA Officer, Assistant Security Officer

Suzanne Gibson
Assistant Vice President, Portfolio Management Officer

Woody Odom
Assistant Vice President, IT/IS

Joanna Watts
IT/IS Officer

Rhonda Sanders
Deposit Operations, Customer Identification Program Officer

Leigh Ann Thompson
Data Analytics Officer

Opelika Branch Advisory Board

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

William H. Brown
President, Brown Agency, Inc.

William G. Dyas
Realtor, First Realty

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

William P. Johnston
President, J & M Bookstore

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

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

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

Auburn National Bancorporation, Inc.

FINANCIAL HIGHLIGHTS

(Dollars in thousands, except per share data)

	For the Years Ended December 31,				
	2018	**2017**	**2016**	**2015**	**2014**
Earnings					
Net Interest Income	$25,570	$24,526	$22,732	$22,718	$21,453
Provision for Loan Losses	——	<300>	<485>	200	50
Net Earnings	8,834	7,846	8,150	7,858	7,448
Per Share:					
Net Earnings	2.42	2.15	2.24	2.16	2.04
Cash Dividends	0.96	0.92	0.90	0.88	0.86
Book Value	24.44	23.85	22.55	21.94	20.80
Shares Issued	3,957,135	3,957,135	3,957,135	3,957,135	3,957,135
Weighted Average Shares Outstanding	3,643,780	3,643,616	3,643,504	3,643,428	3,643,278
Financial Condition					
Total Assets	818,077	853,381	831,943	817,189	789,231
Loans, net of unearned income	476,908	453,651	430,946	426,410	402,954
Investment Securities	239,801	257,697	243,572	241,687	267,603
Total Deposits	724,193	757,659	739,143	723,627	693,390
Long Term Debt	——	3,217	3,217	7,217	12,217
Stockholders' Equity	89,055	86,906	82,177	79,949	75,799
Selected Ratios					
Return on Average Total Assets	1.08%	0.94%	0.98%	0.98%	0.97%
Return on Average Total Equity	10.14%	9.17%	9.65%	9.98%	10.53%
Average Stockholders' Equity to Average Assets	10.63%	10.30%	10.14%	9.79%	9.17%
Allowance for Loan Losses as a % of Loans	1.00%	1.05%	1.08%	1.01%	1.20%
Loans to Total Deposits	65.85%	59.88%	58.30%	58.93%	58.11%

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Financial Section

Auburn National Bancorporation, Inc. 2018 Annual Report

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SPECIAL CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as “may,” “will,” “anticipate,” “assume,” “should,” “indicate,” “would,” “believe,” “contemplate,” “expect,” “estimate,” “continue,” “plan,” “point to,” “project,” “could,” “intend,” “target” and other similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation, (i) the effects of future economic, business and market conditions and changes, domestic and foreign, including seasonality; (ii) governmental monetary and fiscal policies; (iii) legislative and regulatory changes, including changes in banking, securities and tax laws, regulations and rules and their application by our regulators, including capital and liquidity requirements, and changes in the scope and cost of FDIC insurance; (iv) changes in accounting policies, rules and practices; (v) the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest-sensitive assets and liabilities, and the risks and uncertainty of the amounts realizable; (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, including the disruption effects of financial technology and other competitors who are not subject to the same regulations as the Company and the Bank; (x) the failure of assumptions and estimates underlying the establishment of allowances for possible loan losses and other asset impairments, losses valuations of assets and liabilities 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 tests and other evaluations; (xvi) the risks that our deferred tax assets (“DTAs”), if any, 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” herein and in any of our subsequent reports that we make with the Securities and Exchange Commission (the “Commission” or “SEC”) under the Exchange Act.

All written or oral forward-looking statements that are made by us or are attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made.

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 13 locations in its primary service area. The Bank offers Visa® Checkcards, which are debit cards with the Visa logo that work like checks but can be used anywhere Visa is accepted, including ATMs. The Bank's Visa Checkcards can be used internationally through the Plus® network. The Bank offers online banking, bill payment and other electronic services through its Internet website, *www.auburnbank.com*. Our online banking services, bill payment and electronic services are subject to certain cybersecurity risks. See "Risk Factors – Our information systems may experience interruptions and security breaches.

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. For example, 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 nearby Kia and Hyundai automotive 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, 2018 and 2017 and our results of operations for the years ended December 31, 2018 and 2017. The purpose of this discussion is to provide information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein. In addition, this discussion and analysis contains forward-looking statements, so you should refer to Item 1A, "Risk Factors" and "Special Cautionary Notice Regarding Forward-Looking Statements".

OVERVIEW

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

Summary of Results of Operations

	Year ended December 31	
(Dollars in thousands, except per share data)	**2018**	**2017**
Net interest income (a)	$ 26,183	$ 25,731
Less: tax-equivalent adjustment	613	1,205
Net interest income (GAAP)	25,570	24,526
Noninterest income	3,325	3,441
Total revenue	28,895	27,967
Provision for loan losses	—	(300)
Noninterest expense	17,874	16,784
Income tax expense	2,187	3,637
Net earnings	$ 8,834	$ 7,846
Basic and diluted net earnings per share	$ 2.42	$ 2.15

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

Financial Summary

The Company's net earnings were $8.8 million for the full year 2018, compared to $7.8 million for the full year 2017. Basic and diluted net earnings per share were $2.42 per share for the full year 2018, compared to $2.15 per share for the full year 2017.

Net interest income (tax-equivalent) was $26.2 million in 2018, a 2% increase compared to $25.7 million in 2017. This increase was primarily due to loan growth and recent increases in short-term market interest rates, offset by declines on yields of tax exempt securities. Average loans were up 3% to $456.3 million in 2018, compared to $441.0 million in 2017. The Company's net interest margin (tax-equivalent) increased to 3.40% in 2018, compared to 3.29% in 2017 as yields on earning assets improved.

The Company recorded no provision for loan losses during 2018 and a negative provision for loan losses of $0.3 million during the 2017. The provision for loan losses is based upon various estimates and judgements, including the absolute level of loans, loan growth, credit quality and the amount of net charge-offs. Annualized net recoveries as a percent of average loans were 0.01% and 0.09% for 2018 and 2017, respectively. The Company recognized a recovery of $0.4 million from the payoff of two nonperforming commercial loans during 2017.

Noninterest income was $3.3 million in 2018 compared to $3.4 million in 2017. This decrease was primarily due to a $0.1 million decrease in mortgage lending income as production volume declined.

Noninterest expense was $17.9 million compared to $16.8 million in 2017. This increase in noninterest expense was primarily due to increases in salaries and benefits expense of $0.6 million and a $0.4 million loss related to misappropriation of assets, for which the Company filed a claim with its insurance provider. In March 2019, the Company received a settlement of $0.3 million from its insurance provider related to this claim.

Income tax expense was $2.2 million in 2018 and $3.6 million in 2017 reflecting an effective tax rate of 19.84% and 31.67%, respectively. The decrease in the income tax expense and effective tax rate was primarily due to the 2017 Tax Act which lowered the Company's statutory federal tax rate from 34% in 2017 to 21% in 2018 and required the Company to remeasure the value of its net deferred tax assets by $0.4 million as of December 31, 2017.

The Company paid cash dividends of $0.96 per share in 2018, an increase of 4.3% from 2017. At December 31, 2018, the Bank's regulatory capital ratios were well above the minimum amounts required to be "well capitalized" under current regulatory standards with a total risk-based capital ratio of 17.38%, a tier 1 leverage ratio of 11.33% and common equity tier 1 ("CET1") of 16.49% at December 31, 2018.

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, 2018 and 2017, 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. Since the fourth quarter of 2016, the Company has increased its look-back period each quarter to incorporate the effects of at least one economic downturn in its loss history. The Company believes the extension of its look-back period is appropriate due to the risks inherent in the loan portfolio. Absent this extension, the early cycle periods in which the Company experienced significant losses would be excluded from the determination of the allowance for loan losses and its balance would decrease. For the year ended December 31, 2018, the Company increased its look-back period to 39 quarters to continue to include losses incurred by the Company beginning with the first quarter of 2009. The Company will likely continue to increase its look-back period to incorporate the effects of at least one economic downturn in its loss history. Other than expanding the look-back period each quarter, the Company has not made any material changes to its methodology that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

Assessment for Other-Than-Temporary Impairment of Securities

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

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

Fair Value Determination

U.S. GAAP requires management to value and disclose certain of the Company's assets and liabilities at fair value, including investments classified as available-for-sale and derivatives. ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 16, 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, 2018. 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				
	2018			2017	
(Dollars in thousands)		Average Balance	Yield/ Rate		Average Balance	Yield/ Rate
Loans and loans held for sale	$	457,610	4.76%	$	442,101	4.70%
Securities - taxable		181,485	2.23%		197,108	2.15%
Securities - tax-exempt (a)		71,065	4.11%		69,881	5.07%
Total securities		252,550	2.76%		266,989	2.91%
Federal funds sold		28,689	1.93%		32,342	1.05%
Interest bearing bank deposits		31,339	1.81%		41,317	1.04%
Total interest-earning assets		770,188	3.88%		782,749	3.75%
Deposits:						
NOW		125,533	0.34%		125,935	0.20%
Savings and money market		220,810	0.39%		230,121	0.37%
Certificates of deposits		184,010	1.27%		198,457	1.18%
Total interest-bearing deposits		530,353	0.68%		554,513	0.62%
Short-term borrowings		2,634	0.68%		3,476	0.52%
Long-term debt		1,022	4.50%		3,217	3.89%
Total interest-bearing liabilities		534,009	0.69%		561,206	0.64%
Net interest income and margin (a)	$	26,183	3.40%	$	25,731	3.29%

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

RESULTS OF OPERATIONS

Net Interest Income and Margin

Net interest income (tax-equivalent) was $26.2 million in 2018, compared to $25.7 million in 2017. This increase was primarily due to loan growth and improved yields on interest-earning assets.

The tax-equivalent yield on total interest-earning assets increased by 13 basis points in 2018 from 2017 to 3.88%. Expansion of our earning asset yields was primarily driven by loan growth and recent increases in short-term market interest rates, which positively impacted the yields on our short-term assets, including federal funds sold and interest bearing bank deposits. This expansion was partially offset by a decrease in the tax-equivalent yield on tax-exempt available-for-sale securities due to a reduction in the Company's statutory federal tax rate from 34% to 21%.

The cost of total interest-bearing liabilities increased 5 basis points in 2018 from 2017 to 0.69%. The increase in our funding costs was primarily due to higher prevailing market interest rates.

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 reduced earning asset yields during the extended period of low interest rates, increased competition for quality loan opportunities, and possible increases in our costs of funds, if the Federal Reserve continues its gradual increase in interest rates. The Company anticipates that this challenging, competitive environment will continue in 2019. However, the Company believes our net interest income should continue to increase in 2019 compared to 2018 primarily due to an increase in average loan balances.

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 Company recorded no provision for loan losses in 2018 and a negative provision for loan losses of $0.3 million for the year ended December 31, 2017.

Net recoveries were $33 thousand, or 0.01% of average loans and $0.4 million, or 0.09% of average loans, for the years ended December 31, 2018 and 2017, respectively. The Company recognized a recovery of $0.4 million from the payoff of two nonperforming commercial loans during 2017.

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 1.00% at December 31, 2018 from 1.05% at December 31, 2017. 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, 2018. 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

	Year ended December 31	
(Dollars in thousands)	**2018**	**2017**
Service charges on deposit accounts	$ 749	$ 746
Mortgage lending	655	777
Bank-owned life insurance	435	442
Securities gains, net	—	51
Other	1,486	1,425
Total noninterest income	$ 3,325	$ 3,441

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 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.

The Company evaluates MSRs 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 2018 and 2017.

	Year ended December 31	
(Dollars in thousands)	**2018**	**2017**
Origination income	$ 311	$ 504
Servicing fees, net	344	272
Decrease in MSR valuation allowance	—	1
Total mortgage lending income	$ 655	$ 777

The decrease in mortgage lending income was primarily due to a decrease in the volume of mortgage loans originated and sold as refinance activity declined. The decrease in origination income was partially offset by an increase in servicing fees, net, as MSR amortization expense decreased.

Noninterest Expense

(Dollars in thousands)	Year ended December 31 2018	2017
Salaries and benefits	$ 10,653	$ 10,011
Net occupancy and equipment	1,465	1,471
Professional fees	902	966
FDIC and other regulatory assessments	310	346
Other	4,544	3,990
Total noninterest expense	$ 17,874	$ 16,784

The increase in salaries and benefits expense reflects an increase in the number of full-time equivalent employees and routine annual increases.

The increase in other noninterest expense was primarily due to a $0.4 million loss related to a misappropriation of assets for which the Company filed a claim with its insurance provider. In March 2019, the Company received a settlement of $0.3 million from its insurance provider related to this claim.

Income Tax Expense

Income tax expense was $2.2 million in 2018 compared to $3.6 million in 2017. The Company's effective income tax rate was 19.84% in 2018, compared to 31.67% in 2017. The decrease was mainly due to decrease in effect tax rate related to the 2017 Tax Cuts and Jobs Act which lowered the Company's statutory federal tax rate from 34% to 21% and required the Company to remeasure the value of its net deferred tax assets by $0.4 million as of December 31, 2017.

BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale were $239.8 million at December 31, 2018, a decrease of $17.9 million, or 7%, compared to $257.7 million as of December 31, 2017. This decline reflects a decrease in the amortized cost basis of securities available-for-sale of $13.6 million as proceeds from principal repayments on mortgage-backed securities were not reinvested and a decrease in the fair value of securities available-for-sale of $4.3 million. The average tax-equivalent yields earned on total securities were 2.76% in 2018 and 2.91% in 2017.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2018 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, 2018
(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Total Fair Value
Agency obligations	$ 14,437	19,865	16,869	—	51,171
Agency RMBS	—	—	8,368	110,230	118,598
State and political subdivisions	—	3,682	7,726	58,624	70,032
Total available-for-sale	$ 14,437	23,547	32,963	168,854	239,801
Weighted average yield:					
Agency obligations	1.96%	1.71%	2.11%	—	1.91%
Agency RMBS	—	—	2.49%	2.50%	2.50%
State and political subdivisions	—	3.87%	3.02%	3.22%	3.23%
Total available-for-sale	1.96%	2.05%	2.42%	2.75%	2.59%

Loans

(In thousands)					December 31
	2018	2017	2016	2015	2014
Commercial and industrial	$ 63,467	59,086	49,850	52,479	54,329
Construction and land development	40,222	39,607	41,650	43,694	37,298
Commercial real estate	261,896	239,033	220,439	203,853	192,006
Residential real estate	102,597	106,863	110,855	116,673	107,641
Consumer installment	9,295	9,588	8,712	10,220	12,335
Total loans	477,477	454,177	431,506	426,919	403,609
Less: unearned income	(569)	(526)	(560)	(509)	(655)
Loans, net of unearned income	$ 476,908	453,651	430,946	426,410	402,954

Total loans, net of unearned income, were $476.9 million at December 31, 2018, an increase of $23.3 million, or 5%, from $453.7 million at December 31, 2017. Four loan categories represented the majority of the loan portfolio at December 31, 2018: commercial real estate mortgage loans (55%), residential real estate mortgage loans (22%), commercial and industrial loans (13%) and construction and land development loans (8%). Approximately 22% of the Company's commercial real estate loans were classified as owner-occupied at December 31, 2018.

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately $12.3 million, or 3%, and $12.6 million, or 3%, of total loans, net of unearned income at December 31, 2018 and 2017, respectively. For residential real estate mortgage loans with a consumer purpose, approximately $0.5 million and $2.1 million required interest-only payments at December 31, 2018 and 2017, 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 $5.4 million and $1.4 million as of December 31, 2018 and 2017, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company's normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures described under "Critical Accounting Policies – Allowance for Loan Losses".

The average yield earned on loans and loans held for sale was 4.76% in 2018 and 4.70% in 2017.

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 $19.3 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of $17.4 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At December 31, 2018, the Bank had no loan relationships exceeding our internal limit.

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, 2018 (and related balances at December 31, 2017).

	December 31	
(In thousands)	**2018**	**2017**
Hotel/motel	$ 47,936	$ 22,384
Lessors of 1-4 family residential properties	46,374	47,323
Multi-family residential properties	40,455	52,167
Shopping centers	35,789	39,966
Office buildings	25,421	24,483

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, 2018 and 2017, respectively, the allowance for loan losses was $4.8 million 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, 2018 is presented below.

	Year ended December 31				
(Dollars in thousands)	**2018**	**2017**	**2016**	**2015**	**2014**
Allowance for loan losses:					
Balance at beginning of period	$ 4,757	4,643	4,289	4,836	5,268
Charge-offs:					
Commercial and industrial	(52)	(449)	(97)	(100)	(46)
Construction and land development	—	—	—	—	(235)
Commercial real estate	(38)	—	(194)	(866)	—
Residential real estate	(26)	(107)	(182)	(89)	(438)
Consumer installment	(52)	(40)	(67)	(59)	(89)
Total charge-offs	(168)	(596)	(540)	(1,114)	(808)
Recoveries:					
Commercial and industrial	70	461	29	22	71
Construction and land development	—	347	1,212	17	8
Commercial real estate	19	—	—	—	119
Residential real estate	79	115	127	313	112
Consumer installment	33	87	11	15	16
Total recoveries	201	1,010	1,379	367	326
Net recoveries (charge-offs)	33	414	839	(747)	(482)
Provision for loan losses	—	(300)	(485)	200	50
Ending balance	$ 4,790	4,757	4,643	4,289	4,836
as a % of loans	1.00 %	1.05	1.08	1.01	1.20
as a % of nonperforming loans	2,691 %	160	196	158	433
Net (recoveries) charge-offs as a % of average loans	(0.01) %	(0.09)	(0.19)	0.18	0.12

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 1.00% at December 31, 2018, compared to 1.05% at December 31, 2017. 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 recoveries were $33 thousand, or 0.01%, of average loans in 2018, compared to recoveries of $0.4 million, or 0.09%, in 2017. In 2017, the Company recognized a recovery of $0.4 million from the payoff of two nonperforming commercial loans.

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, 2018 the Company had $0.4 million in nonperforming assets compared to $3.0 million at December 31, 2017. The decrease in nonperforming assets was primarily due to the resolution of two nonperforming commercial real estate loans with a recorded investment of $2.1 million at December 31, 2017.

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

					December 31
(Dollars in thousands)	2018	2017	2016	2015	2014
Nonperforming assets:					
Nonperforming (nonaccrual) loans	$ 178	2,972	2,370	2,714	1,117
Other real estate owned	172	—	152	252	534
Total nonperforming assets	$ 350	2,972	2,522	2,966	1,651
as a % of loans and other real estate owned	0.07 %	0.66	0.59	0.70	0.41
as a % of total assets	0.04 %	0.35	0.30	0.36	0.21
Nonperforming loans as a % of total loans	0.04 %	0.66	0.55	0.64	0.28
Accruing loans 90 days or more past due	$ —	—	—	—	—

The table below provides information concerning the composition of nonaccrual loans at December 31, 2018 and 2017, respectively.

		December 31
(In thousands)	2018	2017
Nonaccrual loans:		
Commercial and industrial	$ —	31
Commercial real estate	—	2,188
Residential real estate	178	739
Consumer installment	—	14
Total nonaccrual loans / nonperforming loans	$ 178	2,972

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, 2018, the Company had $0.2 million in loans on nonaccrual, compared to $3.0 million at December 31, 2017.

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, 2018 and 2017, the Company had $0.2 and $0.5 million, respectively, in accruing TDRs.

At December 31, 2018 and 2017, there were no loans 90 days past due and still accruing interest.

The table below provides information concerning the composition of OREO at December 31, 2018 and 2017, respectively.

		December 31	
(In thousands)		2018	2017
Other real estate owned:			
Residential	$	172	—
Total other real estate owned	$	172	—

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 $6.5 million, or 1.4% of total loans at December 31, 2018, compared to $5.7 million, or 1.3% of total loans at December 31, 2017.

The table below provides information concerning the composition of potential problem loans at December 31, 2018 and 2017, respectively.

		December 31	
(In thousands)		2018	2017
Potential problem loans:			
Commercial and industrial	$	522	119
Construction and land development		741	468
Commercial real estate		688	733
Residential real estate		4,506	4,253
Consumer installment		71	78
Total potential problem loans	$	6,528	5,651

At December 31, 2018, approximately $0.7 million or 10.4% of total potential problem loans were past due at least 30 but less than 90 days.

The following table is a summary of the Company's performing loans that were past due at least 30 days but less than 90 days as of December 31, 2018 and 2017, respectively.

		December 31	
(In thousands)		2018	2017
Performing loans past due 30 to 89 days:			
Commercial and industrial	$	100	8
Construction and land development		225	—
Commercial real estate		—	—
Residential real estate		1,740	1,058
Consumer installment		41	57
Total performing loans past due 30 to 89 days	$	2,106	1,123

Deposits

(In thousands)		December 31 2018	2017
Noninterest bearing demand	$	201,648	193,917
NOW		120,769	146,999
Money market		161,464	173,251
Savings		59,075	55,421
Certificates of deposit under $100,000		62,207	69,960
Certificates of deposit and other time deposits of $100,000 or more		108,620	107,711
Brokered certificates of deposit		10,410	10,400
Total deposits	$	724,193	757,659

Total deposits were $724.2 million and $757.7 million at December 31, 2018 and 2017, respectively. Decreases of $41.2 million in interest-bearing deposits were partially offset by increases in noninterest-bearing deposits of $7.7 million during 2018. Of the $41.2 million decrease in interest-bearing deposits, $28.0 million was due to fluctuations in public depositor account balances.

The average rates paid on total interest-bearing deposits were 0.68% in 2018 and 0.62% in 2017. Noninterest bearing deposits were 28% and 26% of total deposits at December 31, 2018 and 2017, respectively.

Other Borrowings

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity of one year or less. The Bank had available federal fund lines totaling $41.0 million with none outstanding at December 31, 2018 and 2017, respectively. Securities sold under agreements to repurchase totaled $2.3 million and $2.7 million at December 31, 2018 and 2017, respectively.

The average rates paid on short-term borrowings was 0.68% and 0.52% in 2018 and 2017, respectively. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the two-year period ended December 31, 2018 is included in Note 9 to the accompanying consolidated financial statements included in this annual report.

Long-term debt includes junior subordinated debentures related to trust preferred securities. The Company had $3.2 million in junior subordinated debentures related to trust preferred securities outstanding at December 31, 2017. On April 27, 2018, the Company formally redeemed all of the issued and outstanding junior subordinated debentures, including accrued and unpaid distributions, and the Trust formally redeemed all of the issued and outstanding trust preferred securities and common securities at par, including accrued and unpaid distributions. The junior subordinated debentures would have matured on December 31, 2033 and were redeemable since December 31, 2008.

The average rates paid on long-term debt were 4.50% in 2018 and 3.89% in 2017.

CAPITAL ADEQUACY

The Company's consolidated stockholders' equity was $89.1 million and $86.9 million as of December 31, 2018 and 2017, respectively. The change from December 31, 2017 was primarily driven by net earnings of $8.8 million, partially offset by cash dividends paid of $3.5 million and an other comprehensive loss due to the change in unrealized losses on securities available-for-sale, net of tax, of $3.2 million.

The Bank’s Tier 1 leverage ratio was 11.33%, Common Equity Tier 1 (“CET1”) risk-based capital ratio was 16.49%, Tier 1 risk-based capital ratio was 16.49%, and total risk-based capital ratio was 17.38% at December 31, 2018. These ratios exceed the minimum regulatory capital percentages of 5.0% for Tier 1 leverage ratio, 6.5% for CET1 risk-based capital ratio, 8.0% for Tier 1 risk-based capital ratio, and 10.0% for total risk-based capital ratio to be considered “well capitalized.” Based on current regulatory standards, the Bank 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 an acceptable asset/liability composition. 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 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 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 help limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income from gradual changes in interest rates. For changes up or down in rates from management's flat interest rate forecast over the next 12 months, policy limits for net interest income variances are as follows:

- +/- 20% for a gradual change of 400 basis points
- +/- 15% for a gradual change of 300 basis points
- +/- 10% for a gradual change of 200 basis points
- +/- 5% for a gradual change of 100 basis points

The following table reports the variance of net interest income over the next 12 months assuming a gradual change in interest rates up or down when compared to the baseline net interest income forecast at December 31, 2018.

Changes in Interest Rates	Net Interest Income % Variance
400 basis points	(3.47)%
300 basis points	(2.13)
200 basis points	(1.16)
100 basis points	(0.82)
(100) basis points	0.92
(200) basis points	0.08
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2018, our earnings simulation model indicated that we were in compliance with the policy guidelines noted above.

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 stated policy guidelines for an instantaneous basis point change in interest rates, such that our EVE should not decrease from our base case by more than the following:

- 45% for an instantaneous change of +/- 400 basis points
- 35% for an instantaneous change of +/- 300 basis points
- 25% for an instantaneous change of +/- 200 basis points
- 15% for an instantaneous change of +/- 100 basis points

The following table reports the variance of EVE assuming an immediate change in interest rates up or down when compared to the baseline EVE at December 31, 2018.

Changes in Interest Rates	EVE % Variance
400 basis points	(21.50) %
300 basis points	(15.62)
200 basis points	(10.03)
100 basis points	(4.56)
(100) basis points	0.45
(200) basis points	(5.77)
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2018, our EVE model indicated that we were in compliance with the policy guidelines noted above.

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

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps ("swaps") to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2018 and 2017, 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, 2018, the Bank had a remaining available line of credit with the FHLB totaling $238.6 million. As of December 31, 2018, the Bank also had $41.0 million of federal funds lines, with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

The following table presents additional information about our contractual obligations as of December 31, 2018, which by their terms had contractual maturity and termination dates subsequent to December 31, 2018:

		Payments due by period				
			1 year	1 to 3	3 to 5	More than
(Dollars in thousands)		Total	or less	years	years	5 years
Contractual obligations:						
Deposit maturities (1)	$	724,193	651,319	45,518	27,356	—
Operating lease obligations		718	152	161	120	285
Total	$	724,911	651,471	45,679	27,476	285

(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, 2018, the Bank had outstanding standby letters of credit of $7.0 million and unfunded loan commitments outstanding of $61.9 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase federal funds from other financial institutions.

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, 2018, the unpaid principal balance of residential mortgage loans, which we have originated and sold, but retained the servicing rights was $290.0 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 2018, as a result of the representation and warranty provisions contained in the Company's sale agreements with Fannie Mae, the Company was required to repurchase one loan with an aggregate principal balance of $53 thousand, which was current as to principal and interest at the time of repurchase. During 2017, the Company was required to repurchase three loans with an aggregate principal balance of $0.6 million that were current as to principal and interest at the time of repurchase. At December 31, 2018, the Company had no pending repurchase requests related to representation and warranty provisions.

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, 2018, 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 2016-02, *Leases;*
- ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments;*
- ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities;*
- ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement; and*
- ASU 2018-15, *Intangibles – Goodwill and Other – Internal Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract*.

Information about these pronouncements is described in more detail below.

ASU 2016-02, *Leases,* requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. In July 2018, the FASB issued ASU 2018-10 and 2018-11, which are designed to make targeted improvements to and clarifications regarding ASU 2016-02. The new guidance is effective for annual and interim reporting periods beginning after December 15, 2018. The amendment should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently finalizing its evaluation of its lease obligations as potential lease assets and liabilities as defined by ASU 2016-02. Based on the Company's preliminary analysis of its existing lease contracts, it is estimated that the adoption of ASU 2016-02 will result in a right-of-use asset and a lease liability of approximately $0.6 million from operating leases, primarily from our facilities.

ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): – Measurement of Credit Losses on Financial Instruments*, amends guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. For assets held at amortized cost basis, the new standard eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses using a broader range of information regarding past events, current conditions and forecasts assessing the collectability of cash flows. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. For available for sale debt securities, credit losses should be measured in a manner similar to current GAAP, however the new standard will require that credit losses be presented as an allowance rather than as a write-down. The new guidance affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. For public business entities that are SEC filers, the new guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2019, and early adoption is permitted beginning in 2019. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). The Company is planning to adopt the standard in the first quarter of 2020 and is continuing its implementation efforts through its Company-wide implementation team. This team has assigned roles and responsibilities, key tasks to complete, and a general timeline to be followed. The team meets periodically to discuss the latest developments and ensure progress is being made. The team has been working with an advisory consultant and is finalizing the methodologies that will be utilized, which will be followed by developing and documenting processes, controls, policies and disclosure requirements in preparation for performing a full parallel run. The Company's preliminary evaluation indicates the provisions of ASU No. 2016-13 are expected to impact the Company's Consolidated Financial Statements, in particular the level of the reserve for credit losses. The Company is continuing to evaluate the extent of the potential impact and expects that portfolio composition and economic conditions at the time of adoption will be a factor.

ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*, improves the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and reduces the complexity of and simplifies the application of hedge accounting by preparers. For public entities, the guidance is effective for fiscal years beginning after December 15, 2018, and interim periods therein; however, early adoption by all entities is permitted. The Company is currently evaluating this ASU to determine whether its provisions will enhance the Company's ability to employ risk management strategies, while improving the transparency and understanding of those strategies for financial statement users.

ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement,* improves the disclosure requirements on fair value measurements by eliminating the requirements to disclose (i) the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy; (ii) the policy for timing of transfers between levels; and (iii) the valuation processes for Level 3 fair value measurements. This ASU also added specific disclosure requirements for fair value measurements for public entities including the requirement to disclose the changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements.

The amendments in this ASU are effective for all entities for fiscal years beginning after December 15, 2019, and all interim periods within those fiscal years. Early adoption is permitted upon issuance of the ASU. Entities are permitted to early adopt amendments that remove or modify disclosures and delay the adoption of the additional disclosures until their effective date. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

ASU 2018- 15, *Intangibles – Goodwill and Other – Internal Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract* aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include internal-use software license). This ASU requires entities to use the guidance in FASB ASC 350-40, Intangibles - Goodwill and Other - Internal Use Software, to determine whether to capitalize or expense implementation costs related to the service contract. This ASU also requires entities to (i) expense capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement; (ii) present the expense related to the capitalized implementation costs in the same line item on the income statement as fees associated with the hosting element of the arrangement; (iii) classify payments for capitalized implementation costs in the statement of cash flows in the same manner as payments made for fees associated with the hosting element; and (iv) present the capitalized implementation costs in the same balance sheet line item that a prepayment for the fees associated with the hosting arrangement would be presented.

The amendments in this ASU are effective for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

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 is presented below.

		Year ended December 31				
(In thousands)		**2018**	**2017**	**2016**	**2015**	**2014**
Net interest income (GAAP)	$	25,570	24,526	22,732	22,718	21,453
Tax-equivalent adjustment		613	1,205	1,276	1,342	1,288
Net interest income (Tax-equivalent)	$	26,183	25,731	24,008	24,060	22,741

Table 2 - Selected Financial Data

(Dollars in thousands, except per share amounts)					Year ended December 31
	2018	2017	2016	2015	2014
Income statement					
Tax-equivalent interest income (a)	$ 29,859	29,325	28,092	28,495	28,105
Total interest expense	3,676	3,594	4,084	4,435	5,364
Tax equivalent net interest income (a)	26,183	25,731	24,008	24,060	22,741
Provision for loan losses	—	(300)	(485)	200	50
Total noninterest income	3,325	3,441	3,383	4,532	3,933
Total noninterest expense	17,874	16,784	15,348	16,372	15,104
Net earnings before income taxes and tax-equivalent adjustment	11,634	12,688	12,528	12,020	11,520
Tax-equivalent adjustment	613	1,205	1,276	1,342	1,288
Income tax expense	2,187	3,637	3,102	2,820	2,784
Net earnings	$ 8,834	7,846	8,150	7,858	7,448
Per share data:					
Basic and diluted net earnings	$ 2.42	2.15	2.24	2.16	2.04
Cash dividends declared	$ 0.96	0.92	0.90	0.88	0.86
Weighted average shares outstanding					
Basic and diluted	3,643,780	3,643,616	3,643,504	3,643,428	3,643,278
Shares outstanding	3,643,868	3,643,668	3,643,523	3,643,478	3,643,328
Book value	$ 24.44	23.85	22.55	21.94	20.80
Common stock price					
High	$ 53.50	40.25	31.31	30.39	25.80
Low	28.88	30.75	24.56	23.15	22.10
Period-end	$ 31.66	38.90	31.31	29.62	23.64
To earnings ratio	13.08x	18.09	13.98	13.78	11.59
To book value	130 %	163	139	135	114
Performance ratios:					
Return on average equity	10.14 %	9.17	9.65	9.98	10.53
Return on average assets	1.08 %	0.94	0.98	0.98	0.97
Dividend payout ratio	39.67 %	42.79	40.18	40.74	42.16
Average equity to average assets	10.63 %	10.30	10.14	9.79	9.17
Asset Quality:					
Allowance for loan losses as a % of:					
Loans	1.00 %	1.05	1.08	1.01	1.20
Nonperforming loans	2,691 %	160	196	158	433
Nonperforming assets as a % of:					
Loans and other real estate owned	0.07 %	0.66	0.59	0.70	0.41
Total assets	0.04 %	0.35	0.30	0.36	0.21
Nonperforming loans as % of loans	0.04 %	0.66	0.55	0.64	0.28
Net (recoveries) charge-offs as a % of average loans	(0.01) %	(0.09)	(0.19)	0.18	0.12
Capital Adequacy:					
CET 1 risk-based capital ratio	16.49 %	16.42	16.44	15.28	na
Tier 1 risk-based capital ratio	16.49 %	16.98	17.00	16.57	17.45
Total risk-based capital ratio	17.38 %	17.91	17.95	17.44	18.54
Tier 1 leverage ratio	11.33 %	10.95	10.27	10.35	10.32
Other financial data:					
Net interest margin (a)	3.40 %	3.29	3.05	3.17	3.15
Effective income tax rate	19.84 %	31.67	27.57	26.41	27.21
Efficiency ratio (b)	60.57 %	57.53	56.03	57.26	56.62
Selected period end balances:					
Securities	$ 239,801	257,697	243,572	241,687	267,603
Loans, net of unearned income	476,908	453,651	430,946	426,410	402,954
Allowance for loan losses	4,790	4,757	4,643	4,289	4,836
Total assets	818,077	853,381	831,943	817,189	789,231
Total deposits	724,193	757,659	739,143	723,627	693,390
Long-term debt	—	3,217	3,217	7,217	12,217
Total stockholders' equity	89,055	86,906	82,177	79,949	75,799

(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 - Average Balance and Net Interest Income Analysis

	Year ended December 31					
	2018			2017		
(Dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Interest-earning assets:						
Loans and loans held for sale (1)	$ 457,610	$ 21,766	4.76%	$ 442,101	$ 20,781	4.70%
Securities - taxable	181,485	4,051	2.23%	197,108	4,229	2.15%
Securities - tax-exempt (2)	71,065	2,921	4.11%	69,881	3,545	5.07%
Total securities	252,550	6,972	2.76%	266,989	7,774	2.91%
Federal funds sold	28,689	554	1.93%	32,342	341	1.05%
Interest bearing bank deposits	31,339	567	1.81%	41,317	429	1.04%
Total interest-earning assets	770,188	29,859	3.88%	782,749	29,325	3.75%
Cash and due from banks	13,802			13,386		
Other assets	35,539			34,291		
Total assets	$ 819,529			$ 830,426		
Interest-bearing liabilities:						
Deposits:						
NOW	$ 125,533	428	0.34%	$ 125,935	248	0.20%
Savings and money market	220,810	855	0.39%	230,121	852	0.37%
Certificates of deposits	184,010	2,329	1.27%	198,457	2,351	1.18%
Total interest-bearing deposits	530,353	3,612	0.68%	554,513	3,451	0.62%
Short-term borrowings	2,634	18	0.68%	3,476	18	0.52%
Long-term debt	1,022	46	4.50%	3,217	125	3.89%
Total interest-bearing liabilities	534,009	3,676	0.69%	561,206	3,594	0.64%
Noninterest-bearing deposits	195,924			180,891		
Other liabilities	2,489			2,788		
Stockholders' equity	87,107			85,541		
Total liabilities and and stockholders' equity	$ 819,529			$ 830,426		
Net interest income and margin		$ 26,183	3.40%		$ 25,731	3.29%

(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 21% for 2018 and 34% for prior years.

Table 4 - Volume and Rate Variance Analysis

	Years ended December 31, 2018 vs. 2017			Years ended December 31, 2017 vs. 2016		
	Net	Due to change in		Net	Due to change in	
(Dollars in thousands)	Change	Rate (2)	Volume (2)	Change	Rate (2)	Volume (2)
Interest income:						
Loans and loans held for sale	$ 985	247	738	$ 328	(138)	466
Securities - taxable	(178)	171	(349)	947	298	649
Securities - tax-exempt (1)	(624)	(673)	49	(209)	(279)	70
Total securities	(802)	(502)	(300)	738	19	719
Federal funds sold	213	284	(71)	92	272	(180)
Interest bearing bank deposits	138	319	(181)	75	373	(298)
Total interest income	$ 534	348	186	$ 1,233	526	707
Interest expense:						
Deposits:						
NOW	$ 180	181	(1)	$ (85)	(93)	8
Savings and money market	3	39	(36)	(38)	(29)	(9)
Certificates of deposits	(22)	161	(183)	(267)	(99)	(168)
Total interest-bearing deposits	161	381	(220)	(390)	(221)	(169)
Short-term borrowings	—	6	(6)	3	—	3
Long-term debt	(79)	20	(99)	(103)	24	(127)
Total interest expense	82	407	(325)	(490)	(197)	(293)
Net interest income	$ 452	(59)	511	$ 1,723	723	1,000

(1) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 21% for 2018 and 34% for prior years.

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

Table 5 - Loan Portfolio Composition

(In thousands)					December 31
	2018	2017	2016	2015	2014
Commercial and industrial	$ 63,467	59,086	49,850	52,479	54,329
Construction and land development	40,222	39,607	41,650	43,694	37,298
Commercial real estate	261,896	239,033	220,439	203,853	192,006
Residential real estate	102,597	106,863	110,855	116,673	107,641
Consumer installment	9,295	9,588	8,712	10,220	12,335
Total loans	477,477	454,177	431,506	426,919	403,609
Less: unearned income	(569)	(526)	(560)	(509)	(655)
Loans, net of unearned income	476,908	453,651	430,946	426,410	402,954
Less: allowance for loan losses	(4,790)	(4,757)	(4,643)	(4,289)	(4,836)
Loans, net	$ 472,118	448,894	426,303	422,121	398,118

Table 6 - Loan Maturities and Sensitivities to Changes in Interest Rates

							December 31, 2018
(Dollars in thousands)	1 year or less	1 to 5 years	After 5 years	Total	Adjustable Rate	Fixed Rate	Total
Commercial and industrial	$ 37,237	9,600	16,630	63,467	21,505	41,962	63,467
Construction and land development	22,910	16,420	892	40,222	16,016	24,206	40,222
Commercial real estate	34,196	98,083	129,617	261,896	11,932	249,964	261,896
Residential real estate	9,654	26,347	66,596	102,597	50,992	51,605	102,597
Consumer installment	3,359	5,372	564	9,295	422	8,873	9,295
Total loans	$ 107,356	155,822	214,299	477,477	100,867	376,610	477,477

Table 7 - Allowance for Loan Losses and Nonperforming Assets

(Dollars in thousands)	Year ended December 31 2018	2017	2016	2015	2014
Allowance for loan losses:					
Balance at beginning of period	$ 4,757	4,643	4,289	4,836	5,268
Charge-offs:					
Commercial and industrial	(52)	(449)	(97)	(100)	(46)
Construction and land development	—	—	—	—	(235)
Commercial real estate	(38)	—	(194)	(866)	—
Residential real estate	(26)	(107)	(182)	(89)	(438)
Consumer installment	(52)	(40)	(67)	(59)	(89)
Total charge-offs	(168)	(596)	(540)	(1,114)	(808)
Recoveries:					
Commercial and industrial	70	461	29	22	71
Construction and land development	—	347	1,212	17	8
Commercial real estate	19	—	—	—	119
Residential real estate	79	115	127	313	112
Consumer installment	33	87	11	15	16
Total recoveries	201	1,010	1,379	367	326
Net recoveries (charge-offs)	33	414	839	(747)	(482)
Provision for loan losses	—	(300)	(485)	200	50
Ending balance	$ 4,790	4,757	4,643	4,289	4,836
as a % of loans	1.00 %	1.05	1.08	1.01	1.20
as a % of nonperforming loans	2,691 %	160	196	158	433
Net (recoveries) charge-offs as % of average loans	(0.01) %	(0.09)	(0.19)	0.18	0.12
Nonperforming assets:					
Nonaccrual/nonperforming loans	$ 178	2,972	2,370	2,714	1,117
Other real estate owned	172	—	152	252	534
Total nonperforming assets	$ 350	2,972	2,522	2,966	1,651
as a % of loans and other real estate owned	0.07 %	0.66	0.59	0.70	0.41
as a % total assets	0.04 %	0.35	0.30	0.36	0.21
Nonperforming loans as a % of total loans	0.04 %	0.66	0.55	0.64	0.28
Accruing loans 90 days or more past due	$ —	—	—	—	—

Table 8 - Allocation of Allowance for Loan Losses

	December 31									
	2018		2017		2016		2015		2014	
(Dollars in thousands)	**Amount**	**%***	**Amount**	**%***	**Amount**	**%***	**Amount**	**%***	**Amount**	**%***
Commercial and industrial	$ 778	13.3	$ 653	13.0	$ 540	11.6	$ 523	12.3	$ 639	13.5
Construction and land development	700	8.4	734	8.7	812	9.7	669	10.2	974	9.2
Commercial real estate	2,218	54.9	2,126	52.7	2,071	51.0	1,879	47.8	1,928	47.5
Residential real estate	946	21.5	1,071	23.5	1,107	25.7	1,059	27.3	1,119	26.7
Consumer installment	148	1.9	173	2.1	113	2.0	159	2.4	176	3.1
Total allowance for loan losses	$ 4,790		$ 4,757		$ 4,643		$ 4,289		$ 4,836	

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

Table 9 - CDs and Other Time Deposits of $100,000 or More

(Dollars in thousands)		December 31, 2018
Maturity of:		
3 months or less	$	21,837
Over 3 months through 6 months		10,828
Over 6 months through 12 months		39,008
Over 12 months		47,357
Total CDs and other time deposits of $100,000 or more (1)	$	119,030

(1) Includes brokered certificates of deposit.

Management's Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting. Internal control is designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation of reliable published financial statements. Internal control over financial reporting includes self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Because of inherent limitations in any system of internal control, no matter how well designed, misstatements due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the Company's internal control over financial reporting as of December 31, 2018. This assessment was based on criteria for effective internal control over financial reporting described in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework). Based on this assessment, the Chief Executive Officer and Chief Financial Officer assert that the Company maintained effective internal control over financial reporting as of December 31, 2018 based on the specified criteria.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2018 has been audited by Elliott Davis, LLC, the independent registered public accounting firm who also has audited the Company's consolidated financial statements included in this Annual Report on Form 10-K. Elliott Davis, LLC's attestation report on the Company's internal control over financial reporting appears on the following page and is incorporated by reference herein.

Changes in Internal Control Over Financial Reporting

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

Report of Independent Registered Public Accounting Firm

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

Opinion on the Internal Control Over Financial Reporting

We have audited Auburn National Bancorporation, Inc. and its subsidiaries' (the "Company") internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets of the Company as of December 31, 2018 and 2017 and the related consolidated statements of earnings, comprehensive income, stockholders' equity, and cash flows of the Company for the years then ended, and the related notes to the consolidated financial statements and our report dated March 12, 2019 expressed an unqualified opinion.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Elliott Davis, LLC

Greenville, South Carolina
March 12, 2019

Report of Independent Registered Public Accounting Firm

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

Opinion on the Consolidated Financial Statements
We have audited the accompanying consolidated balance sheets of Auburn National Bancorporation, Inc. and its subsidiaries (the "Company") as of December 31, 2018 and 2017, the related consolidated statements of earnings, comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements and schedules (collectively, the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 12, 2019 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion
These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Elliott Davis, LLC

We have served as the Company's auditor since 2015.

Greenville, South Carolina
March 12, 2019

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES
Consolidated Balance Sheets

(Dollars in thousands, except share data)	December 31 2018	2017
Assets:		
Cash and due from banks	$ 13,043	$ 12,942
Federal funds sold	26,918	41,540
Interest bearing bank deposits	25,115	51,046
Cash and cash equivalents	65,076	105,528
Securities available-for-sale	239,801	257,697
Loans held for sale	383	1,922
Loans, net of unearned income	476,908	453,651
Allowance for loan losses	(4,790)	(4,757)
Loans, net	472,118	448,894
Premises and equipment, net	13,596	13,791
Bank-owned life insurance	18,765	18,330
Other assets	8,338	7,219
Total assets	$ 818,077	$ 853,381
Liabilities:		
Deposits:		
Noninterest-bearing	$ 201,648	$ 193,917
Interest-bearing	522,545	563,742
Total deposits	724,193	757,659
Federal funds purchased and securities sold under agreements to repurchase	2,300	2,658
Long-term debt	—	3,217
Accrued expenses and other liabilities	2,529	2,941
Total liabilities	729,022	766,475
Stockholders' equity:		
Preferred stock of $.01 par value; authorized 200,000 shares; issued shares - none	—	—
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,779	3,771
Retained earnings	95,635	90,299
Accumulated other comprehensive loss, net	(3,763)	(566)
Less treasury stock, at cost - 313,267 shares and 313,467 shares at December 31, 2018 and 2017, respectively	(6,635)	(6,637)
Total stockholders' equity	89,055	86,906
Total liabilities and stockholders' equity	$ 818,077	$ 853,381

See accompanying notes to consolidated financial statements

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

(Dollars in thousands, except share and per share data)	Year ended December 31 2018	2017
Interest income:		
Loans, including fees	$ 21,766	$ 20,781
Securities:		
Taxable	4,051	4,229
Tax-exempt	2,308	2,340
Federal funds sold and interest bearing bank deposits	1,121	770
Total interest income	29,246	28,120
Interest expense:		
Deposits	3,612	3,451
Short-term borrowings	18	18
Long-term debt	46	125
Total interest expense	3,676	3,594
Net interest income	25,570	24,526
Provision for loan losses	—	(300)
Net interest income after provision for loan losses	25,570	24,826
Noninterest income:		
Service charges on deposit accounts	749	746
Mortgage lending	655	777
Bank-owned life insurance	435	442
Other	1,486	1,425
Securities gains, net	—	51
Total noninterest income	3,325	3,441
Noninterest expense:		
Salaries and benefits	10,653	10,011
Net occupancy and equipment	1,465	1,471
Professional fees	902	966
FDIC and other regulatory assessments	310	346
Other	4,544	3,990
Total noninterest expense	17,874	16,784
Earnings before income taxes	11,021	11,483
Income tax expense	2,187	3,637
Net earnings	$ 8,834	$ 7,846
Net earnings per share:		
Basic and diluted	$ 2.42	$ 2.15
Weighted average shares outstanding:		
Basic and diluted	3,643,780	3,643,616

See accompanying notes to consolidated financial statements

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(Dollars in thousands)	Year ended December 31 2018	2017
Net earnings	$ 8,834	$ 7,846
Other comprehensive (loss) income, net of tax:		
Unrealized net holding (loss) gain on all other securities	(3,197)	263
Reclassification adjustment for net gain on securities recognized in net earnings	—	(32)
Other comprehensive (loss) income	(3,197)	231
Comprehensive income	$ 5,637	$ 8,077

See accompanying notes to consolidated financial statements

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

(Dollars in thousands, except share data)	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Treasury stock	Total
Balance, December 31, 2016	3,957,135	$ 39	3,767	85,716	(708)	(6,637)	$ 82,177
Net earnings	—	—	—	7,846	—	—	7,846
Other comprehensive income	—	—	—	—	231	—	231
Reclassification of certain tax effects	—	—	—	89	(89)	—	—
Cash dividends paid ($0.92 per share)	—	—	—	(3,352)	—	—	(3,352)
Sale of treasury stock (145 shares)	—	—	4	—	—	—	4
Balance, December 31, 2017	3,957,135	$ 39	$ 3,771	$ 90,299	$ (566)	$ (6,637)	$ 86,906
Net earnings	—	—	—	8,834	—	—	8,834
Other comprehensive loss	—	—	—	—	(3,197)	—	(3,197)
Cash dividends paid ($0.96 per share)	—	—	—	(3,498)	—	—	(3,498)
Sale of treasury stock (200 shares)	—	—	8	—	—	2	10
Balance, December 31, 2018	3,957,135	$ 39	$ 3,779	$ 95,635	$ (3,763)	$ (6,635)	$ 89,055

See accompanying notes to consolidated financial statements

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

	Year ended December 31	
(In thousands)	**2018**	**2017**
Cash flows from operating activities:		
Net earnings	$ 8,834	$ 7,846
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	—	(300)
Depreciation and amortization	938	1,016
Premium amortization and discount accretion, net	2,025	2,133
Deferred tax expense	71	356
Net gain on securities available for sale	—	(51)
Net gain on sale of loans held for sale	(311)	(504)
Net gain on other real estate owned	—	(5)
Loans originated for sale	(27,681)	(29,796)
Proceeds from sale of loans	29,323	29,651
Increase in cash surrender value of bank owned life insurance	(435)	(442)
Net (increase) decrease in other assets	(221)	592
Net decrease in accrued expenses and other liabilities	(402)	(1,095)
Net cash provided by operating activities	$ 12,141	$ 9,401
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	8,770	10,374
Proceeds from maturities of securities available-for-sale	22,673	32,945
Purchase of securities available-for-sale	(19,841)	(59,160)
Increase in loans, net	(24,749)	(22,291)
Net purchases of premises and equipment	(240)	(1,618)
Increase in FHLB stock	(20)	(13)
Proceeds from sale of other real estate owned	1,353	157
Net cash used in investing activities	$ (12,054)	$ (39,606)
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	7,731	12,027
Net (decrease) increase in interest-bearing deposits	(41,197)	6,489
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(358)	(708)
Repayments or retirement of long-term debt	(3,217)	—
Dividends paid	(3,498)	(3,352)
Net cash (used in) provided by financing activities	$ (40,539)	$ 14,456
Net change in cash and cash equivalents	$ (40,452)	$ (15,749)
Cash and cash equivalents at beginning of period	105,528	121,277
Cash and cash equivalents at end of period	$ 65,076	$ 105,528
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 3,616	$ 3,624
Income taxes	2,688	3,289
Supplemental disclosure of non-cash transactions:		
Real estate acquired through foreclosure	$ 1,525	$ —

See accompanying 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 was an affiliate of the Company and was included in these consolidated financial statements pursuant to the equity method of accounting. On April 27, 2018, the Trust was dissolved. 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.

Accounting Standards Adopted in 2018

In 2018, the Company adopted new guidance related to the following Accounting Standards Update ("Update" or "ASU"):

- ASU 2014-09, *Revenue from Contracts with Customers;*
- ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*;
- ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*; and
- ASU 2016-18, *Restricted Cash.*

Information about these pronouncements is described in more detail below.

ASU 2014-09*, Revenue from Contracts with Customers (Topic 606),* was developed as a joint project with the International Accounting Standards Board to remove inconsistencies in revenue requirements and provide a more robust framework for addressing revenue issues. The ASU's core principle is that an entity should recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB issued ASU 2015-14, which deferred the effective date by one year (i.e., interim and annual reporting periods beginning after December 15, 2017). Early adoption was permitted, but not before the original effective date (i.e., interim and annual reporting periods beginning after December 15, 2016). The ASU may be adopted using either a modified retrospective method or a full retrospective method. The Company adopted the ASU during the first quarter of 2018, as required, using a modified retrospective approach. The majority of the Company's revenue stream is generated from interest income on loans and deposits, which are outside the scope of Topic 606. The Company's sources of income that fall within the scope of Topic 606 include service charges on deposits, investment services, interchange fees and gains and losses on sales of other real estate, all of which are presented as components of noninterest income. The Company has evaluated the effect of Topic 606 on these fee-based income streams and concluded that adoption of the standard did not materially impact its financial statements. The following is a summary of the implementation considerations for the revenue streams that fall within the scope of Topic 606:

- Service charges on deposits, investment services, ATM and interchange fees – Fees from these services are either transaction-based, for which the performance obligations are satisfied when the individual transaction is processed, or set periodic service charges, for which the performance obligations are satisfied over the period the service is provided. Transaction-based fees are recognized at the time the transaction is processed, and periodic service charges are recognized over the service period. The adoption of Topic 606 had no impact on the Company's revenue recognition practice for these services.

- *Gains on sales of other real estate* – ASU 2014-09 creates Topic 610-20, under which a gain on sale should be recognized when a contract for sale exists and control of the asset has been transferred to the buyer. Topic 606 lists several criteria required to conclude that a contract for sale exists, including a determination that the institution will collect substantially all of the consideration to which it is entitled. This presents a key difference between the prior and new guidance related to the recognition of the gain when the institution finances the sale of the property. Rather than basing recognition on the amount of the buyer's initial investment, which was the primary consideration under prior guidance, the analysis is now based on various factors including not only the loan to value, but also the credit quality of the borrower, the structure of the loan, and any other factors that may affect collectability. While these differences may affect the decision to recognize or defer gains on sales of other real estate in circumstances where the Company has financed the sale, the effects would not be material to its consolidated financial statements.

ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Some of the amendments include the following: (1) Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (2) Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (4) Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others. For public business entities, the amendments of this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of this ASU on January 1, 2018 did not have a material impact on the Company's Consolidated Financial Statements. In accordance with (3) above, the Company measured the fair value of its loan portfolio as of December 31, 2018 using an exit price notion and will continue to do so going forward. See Note 16, Fair Value.

ASU 2016-15*, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments,* provides guidance on eight specific cash flow issues where current GAAP is either unclear or does not include specific guidance on classification in the statement of cash flows. The new guidance is effective for annual and interim reporting periods in fiscal years beginning after December 15, 2017. The Company adopted ASU No. 2016-15 on January 1, 2018. ASU No. 2016-15 did not have a material impact on the Company's Consolidated Financial Statements.

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*, amends guidance on how the statement of cash flows presents the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Under the new guidance, amounts generally described as restricted cash and restricted cash equivalents are included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments in this Update do not provide a definition of restricted cash or restricted cash equivalents. The new guidance is effective for public business entities for annual and interim reporting periods in fiscal years beginning after December 15, 2017. The Company adopted ASU No. 2016-18 on January 1, 2018. ASU No. 2016-18 did not have a material impact on the Company's Consolidated Financial Statements.

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, 2018, 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 (loss), net of the deferred income tax effects. Interest and dividends on securities, including the amortization of premiums and accretion of discounts are recognized in interest income over the anticipated life of the security using the effective interest method, taking into consideration prepayment assumptions. Realized gains and losses from the sale of securities are determined using the specific identification method.

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

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

Loans held for sale

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

In the course of conducting the Bank's mortgage lending activities of originating mortgage loans and selling those loans in the secondary market, the Bank makes various representations and warranties to the purchaser of the mortgage loans. Every loan closed by the Bank's mortgage center is run through a government agency automated underwriting system. Any exceptions noted during this process are remedied prior to sale. These representations and warranties also apply to underwriting the real estate appraisal opinion of value for the collateral securing these loans. Failure by the Company to comply with the underwriting and/or appraisal standards could result in the Company being required to repurchase the mortgage loan or to reimburse the investor for losses incurred (make whole requests) if such failure cannot be cured by the Company within the specified period following discovery.

Loans

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

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

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

Impaired loans also 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 nonmarketable equity securities are accounted for at cost which equals par or redemption value. These securities do not have a readily determinable fair value as their ownership is restricted and there is no market for these securities. These securities can only be redeemed or sold at their par value and only to the respective issuing government supported institution or to another member institution. The Company records these nonmarketable equity securities as a component of other assets, which are periodically evaluated for impairment. Management considers these nonmarketable equity securities to be long-term investments. Accordingly, when evaluating these securities for impairment, management considers the ultimate recoverability of the par value rather than by recognizing temporary declines in value.

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 MSRs. The Company determines the fair value of MSRs at the date the loan is transferred. An estimate of the Company's MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees.

Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income. The amortization of MSRs is analyzed monthly and is adjusted to reflect changes in prepayment speeds, as well as other factors. MSRs are evaluated for impairment based on the fair value of those assets. 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 through a charge to earnings. The valuation allowance is adjusted as the fair value changes. MSRs are included in the other assets category in the accompanying consolidated balance sheets.

Derivative Instruments

In accordance with Accounting Standards Codification ("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, *Income Taxes*, 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, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. ASC 820 applies only to fair-value measurements that are already required or permitted by other accounting standards. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. For more information related to fair value measurements, please refer to Note 16, 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, 2018. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

NOTE 2: BASIC AND DILUTED NET 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, 2018 and 2017, respectively, the Company had no such securities or other rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted net earnings per share calculation.

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

	Year ended December 31	
(Dollars in thousands, except share and per share data)	**2018**	**2017**
Basic and diluted:		
Net earnings	$ 8,834	$ 7,846
Weighted average common shares outstanding	3,643,780	3,643,616
Net earnings per share	$ 2.42	$ 2.15

NOTE 3: 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, 2018 and 2017, the Bank did not have a required reserve balance at the Federal Reserve Bank.

NOTE 4: SECURITIES

At December 31, 2018 and 2017, respectively, all securities within the scope of ASC 320, *Investments – Debt and Equity Securities* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at December 31, 2018 and 2017, respectively, are presented below.

(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
December 31, 2018								
Agency obligations (a)	$ 14,437	19,865	16,869	—	51,171	25	1,200	$ 52,346
Agency RMBS (a)	—	—	8,368	110,230	118,598	65	3,738	122,271
State and political subdivisions	—	3,682	7,726	58,624	70,032	518	692	70,206
Total available-for-sale	$ 14,437	23,547	32,963	168,854	239,801	608	5,630	$ 244,823
December 31, 2017								
Agency obligations (a)	$ —	29,253	23,809	—	53,062	79	904	$ 53,887
Agency RMBS (a)	—	—	11,201	121,871	133,072	330	1,639	$ 134,381
State and political subdivisions	—	2,564	9,999	59,000	71,563	1,616	237	$ 70,184
Total available-for-sale	$ —	31,817	45,009	180,871	257,697	2,025	2,780	$ 258,452

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

Securities with aggregate fair values of $133.1 million and $149.4 million at December 31, 2018 and 2017, 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 nonmarketable equity investments. The carrying amounts of nonmarketable equity investments were $1.4 million at December 31, 2018 and 2017, respectively. Nonmarketable equity investments include FHLB of Atlanta stock, Federal Reserve Bank ("FRB") stock, and stock in a privately held financial institution.

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at December 31, 2018 and 2017, 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.

	Less than 12 Months		12 Months or Longer		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2018:						
Agency obligations	$ 4,724	28	44,307	1,172	49,031	$ 1,200
Agency RMBS	12,325	238	99,184	3,500	111,509	3,738
State and political subdivisions	14,840	181	14,384	511	29,224	692
Total	$ 31,889	447	157,875	5,183	189,764	$ 5,630
December 31, 2017:						
Agency obligations	$ 14,381	99	20,353	805	34,734	$ 904
Agency RMBS	53,440	363	50,729	1,276	104,169	1,639
State and political subdivisions	2,009	22	10,155	215	12,164	237
Total	$ 69,830	484	81,237	2,296	151,067	$ 2,780

For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. On a quarterly basis, the Company assesses each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities' amortized cost basis.

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.

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 other-than-temporary impairment charges may occur in the future.

Other-Than-Temporarily Impaired Securities

Credit-impaired debt securities are debt securities where the Company has written down the amortized cost basis of a security for other-than-temporary impairment and the credit component of the loss is recognized in earnings. At December 31, 2018 and 2017, respectively, the Company had no credit-impaired debt securities and there were no additions or reductions in the credit loss component of credit-impaired debt securities during the years ended December 31, 2018 and 2017, respectively.

Realized Gains and Losses

The following table presents the gross realized gains and losses on sales related to securities.

(Dollars in thousands)		Year ended December 31 2018	2017
Gross realized gains	$	—	51
Realized gains, net	$	—	51

NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES

(In thousands)		December 31 2018		2017
Commercial and industrial	$	63,467	$	59,086
Construction and land development		40,222		39,607
Commercial real estate:				
Owner occupied		56,413		44,192
Multifamily		40,455		52,167
Other		165,028		142,674
Total commercial real estate		261,896		239,033
Residential real estate:				
Consumer mortgage		56,223		59,540
Investment property		46,374		47,323
Total residential real estate		102,597		106,863
Consumer installment		9,295		9,588
Total loans		477,477		454,177
Less: unearned income		(569)		(526)
Loans, net of unearned income	$	476,908	$	453,651

Loans secured by real estate were approximately 84.9% of the total loan portfolio at December 31, 2018. At December 31, 2018, the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

In accordance with ASC 310, *Receivables*, 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 three classes: (1) owner occupied (2) multi-family and (3) 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.

- *Multifamily* – primarily includes loans to finance income-producing multi-family properties. Loans in this class include loans for 5 or more unit residential property and apartments leased to 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.

- *Other* – primarily includes loans to finance income-producing commercial properties. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, and warehouses 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.

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, 2018 and 2017.

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
December 31, 2018:						
Commercial and industrial	$ 63,367	100	—	63,467	—	$ 63,467
Construction and land development	39,997	225	—	40,222	—	40,222
Commercial real estate:						
Owner occupied	56,413	—	—	56,413	—	56,413
Multifamily	40,455	—	—	40,455	—	40,455
Other	165,028	—	—	165,028	—	165,028
Total commercial real estate	261,896	—	—	261,896	—	261,896
Residential real estate:						
Consumer mortgage	54,446	1,599	—	56,045	178	56,223
Investment property	46,233	141	—	46,374	—	46,374
Total residential real estate	100,679	1,740	—	102,419	178	102,597
Consumer installment	9,254	41	—	9,295	—	9,295
Total	$ 475,193	2,106	—	477,299	178	$ 477,477
December 31, 2017:						
Commercial and industrial	$ 59,047	8	—	59,055	31	$ 59,086
Construction and land development	39,607	—	—	39,607	—	39,607
Commercial real estate:						
Owner occupied	44,192	—	—	44,192	—	44,192
Multifamily	52,167	—	—	52,167	—	52,167
Other	140,486	—	—	140,486	2,188	142,674
Total commercial real estate	236,845	—	—	236,845	2,188	239,033
Residential real estate:						
Consumer mortgage	58,195	746	—	58,941	599	59,540
Investment property	46,871	312	—	47,183	140	47,323
Total residential real estate	105,066	1,058	—	106,124	739	106,863
Consumer installment	9,517	57	—	9,574	14	9,588
Total	$ 450,082	1,123	—	451,205	2,972	$ 454,177

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 $12 thousand and $140 thousand for the years ended December 31, 2018 and 2017, respectively.

Allowance for Loan Losses

The allowance for loan losses as of and for the years ended December 31, 2018 and 2017, is presented below.

	Year ended December 31	
(In thousands)	2018	2017
Beginning balance	$ 4,757	$ 4,643
Charged-off loans	(168)	(596)
Recovery of previously charged-off loans	201	1,010
Net recoveries	33	414
Provision for loan losses	—	(300)
Ending balance	$ 4,790	$ 4,757

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, 2018 and 2017, 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. Since the fourth quarter of 2016, the Company has increased its look-back period each quarter to incorporate the effects of at least one economic downturn in its loss history. The Company believes the extension of its look-back period is appropriate due to the risks inherent in the loan portfolio. Absent this extension, the early cycle periods in which the Company experienced significant losses would be excluded from the determination of the allowance for loan losses and its balance would decrease. For the year ended December 31, 2018, the Company increased its look-back period to 39 quarters to continue to include losses incurred by the Company beginning with the first quarter of 2009. The Company will likely continue to increase its look-back period to incorporate the effects of at least one economic downturn in its loss history. Other than expanding the look-back period each quarter, the Company has not made any material changes to its methodology 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, 2018 and 2017.

(in thousands)		Commercial and industrial	Construction and land Development	Commercial Real Estate	Residential Real Estate	Consumer Installment		Total
Balance, December 31, 2016	$	540	812	2,071	1,107	113	$	4,643
Charge-offs		(449)	—	—	(107)	(40)		(596)
Recoveries		461	347	—	115	87		1,010
Net recoveries		12	347	—	8	47		414
Provision		101	(425)	55	(44)	13		(300)
Balance, December 31, 2017	$	653	734	2,126	1,071	173	$	4,757
Charge-offs		(52)	—	(38)	(26)	(52)		(168)
Recoveries		70	—	19	79	33		201
Net recoveries		18	—	(19)	53	(19)		33
Provision		107	(34)	111	(178)	(6)		—
Balance, December 31, 2018	$	778	700	2,218	946	148	$	4,790

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, 2018 and 2017.

		Collectively evaluated (1)		Individually evaluated (2)		Total	
(In thousands)		Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
December 31, 2018:							
Commercial and industrial	$	778	63,467	—	—	778	63,467
Construction and land development		700	40,222	—	—	700	40,222
Commercial real estate		2,218	261,739	—	157	2,218	261,896
Residential real estate		946	102,597	—	—	946	102,597
Consumer installment		148	9,295	—	—	148	9,295
Total	$	4,790	477,320	—	157	4,790	477,477
December 31, 2017:							
Commercial and industrial	$	622	59,055	31	31	653	59,086
Construction and land development		734	39,607	—	—	734	39,607
Commercial real estate		2,115	236,322	11	2,711	2,126	239,033
Residential real estate		1,071	106,863	—	—	1,071	106,863
Consumer installment		173	9,588	—	—	173	9,588
Total	$	4,715	451,435	42	2,742	4,757	454,177

(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.

(In thousands)	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
December 31, 2018					
Commercial and industrial	$ 61,568	1,377	522	—	$ 63,467
Construction and land development	39,481	—	741	—	40,222
Commercial real estate:					
Owner occupied	55,942	154	317	—	56,413
Multifamily	40,455	—	—	—	40,455
Other	163,449	1,208	371	—	165,028
Total commercial real estate	259,846	1,362	688	—	261,896
Residential real estate:					
Consumer mortgage	50,903	1,374	3,768	178	56,223
Investment property	45,463	173	738	—	46,374
Total residential real estate	96,366	1,547	4,506	178	102,597
Consumer installment	9,149	75	71	—	9,295
Total	$ 466,410	4,361	6,528	178	$ 477,477
December 31, 2017					
Commercial and industrial	$ 58,842	94	119	31	$ 59,086
Construction and land development	39,049	90	468	—	39,607
Commercial real estate:					
Owner occupied	43,615	240	337	—	44,192
Multifamily	52,167	—	—	—	52,167
Other	139,695	395	396	2,188	142,674
Total commercial real estate	235,477	635	733	2,188	239,033
Residential real estate:					
Consumer mortgage	54,101	1,254	3,586	599	59,540
Investment property	46,463	53	667	140	47,323
Total residential real estate	100,564	1,307	4,253	739	106,863
Consumer installment	9,430	66	78	14	9,588
Total	$ 443,362	2,192	5,651	2,972	$ 454,177

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 thousand 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 thousand 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, 2018 and 2017.

	December 31, 2018			
(In thousands)	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
With no allowance recorded:				
Commercial real estate:				
Owner occupied	$ 157	—	157	
Total commercial real estate	157	—	157	
Total impaired loans	$ 157	—	157	$ —

(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.

	December 31, 2017			
(In thousands)	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
With no allowance recorded:				
Commercial real estate:				
Other	$ 3,630	(1,094)	2,536	
Total commercial real estate	3,630	(1,094)	2,536	
Total	$ 3,630	(1,094)	2,536	
With allowance recorded:				
Commercial and industrial	$ 52	(21)	31	$ 31
Commercial real estate:				
Owner occupied	175	—	175	11
Total commercial real estate	175	—	175	11
Total	$ 227	(21)	206	$ 42
Total impaired loans	$ 3,857	(1,115)	2,742	$ 42

(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.

(In thousands)	Year ended December 31, 2018 Average recorded investment	Year ended December 31, 2018 Total interest income recognized	Year ended December 31, 2017 Average recorded investment	Year ended December 31, 2017 Total interest income recognized
Impaired loans:				
Commercial and industrial	$ 9	—	$ 50	—
Construction and land development	—	—	11	—
Commercial real estate:				
Owner occupied	166	9	184	10
Other	1,145	—	2,096	1
Total commercial real estate	1,311	9	2,280	11
Total	$ 1,320	9	$ 2,341	11

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.

(In thousands)	TDRs Accruing	TDRs Nonaccrual	TDRs Total	Related Allowance
December 31, 2018				
Commercial real estate:				
Owner occupied	$ 157	—	157	$ —
Total commercial real estate	157	—	157	—
Total	$ 157	—	157	$ —
December 31, 2017				
Commercial and industrial	$ —	31	31	$ 31
Commercial real estate:				
Owner occupied	175	—	175	11
Other	287	1,431	1,718	—
Total commercial real estate	462	1,431	1,893	11
Total	$ 462	1,462	1,924	$ 42

At December 31, 2018, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

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

($ in thousands)	Number of contracts		Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
December 31, 2018				
Commercial real estate:				
Other	2	$	1,447	1,447
Total commercial real estate	2		1,447	1,447
Total	2	$	1,447	1,447
December 31, 2017				
Commercial and industrial	1	$	34	34
Commercial real estate:				
Other	1	$	1,275	1,266
Total commercial real estate	1		1,275	1,266
Total	2	$	1,309	1,300

The majority of the loans modified in a TDR during the years ended December 31, 2018 and 2017, 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.

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 year ended December 31, 2018. During the year ended December 31, 2017, the Company had no loans modified in a TDR within the previous 12 months for which there was a payment default.

($ in thousands)	Number of Contracts		Recorded investment (1)
December 31, 2018			
Commercial real estate:			
Other	1	$	1,259
Total commercial real estate	1		1,259
Total	1	$	1,259

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

NOTE 6: PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2018 and 2017 is presented below.

		December 31	
(Dollars in thousands)		2018	2017
Land	$	7,473	7,473
Buildings and improvements		10,438	10,394
Furniture, fixtures, and equipment		3,357	3,161
Total premises and equipment		21,268	21,028
Less: accumulated depreciation		(7,672)	(7,237)
Premises and equipment, net	$	13,596	13,791

Depreciation expense was approximately $435 thousand and $428 thousand for the years ended December 31, 2018 and 2017, respectively, and is a component of net occupancy and equipment expense in the consolidated statements of earnings.

NOTE 7: MORTGAGE SERVICING RIGHTS, NET

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.

The following table details the changes in amortized MSRs and the related valuation allowance for the years ended December 31, 2018 and 2017.

		Year ended December 31	
(Dollars in thousands)		**2018**	**2017**
Beginning balance	$	1,644	1,952
Additions, net		208	224
Amortization expense		(411)	(533)
Change in valuation allowance		—	1
Ending balance	$	1,441	1,644
Valuation allowance included in MSRs, net:			
Beginning of period	$	—	1
End of period		—	—
Fair value of amortized MSRs:			
Beginning of period	$	2,528	2,678
End of period		2,697	2,528

Data and assumptions used in the fair value calculation related to MSRs at December 31, 2018 and 2017, respectively, are presented below.

		December 31	
(Dollars in thousands)		**2018**	**2017**
Unpaid principal balance	$	289,981	312,318
Weighted average prepayment speed (CPR)		8.3 %	10.2
Discount rate (annual percentage)		10.0 %	10.0
Weighted average coupon interest rate		3.9 %	3.8
Weighted average remaining maturity (months)		250	253
Weighted average servicing fee (basis points)		25.0	25.0

At December 31, 2018, the weighted average amortization period for MSRs was 6.7 years. Estimated amortization expense for each of the next five years is presented below.

(Dollars in thousands)	**December 31, 2018**
2019	$ 198
2020	174
2021	152
2022	131
2023	115

NOTE 8: DEPOSITS

At December 31, 2018, the scheduled maturities of certificates of deposit and other time deposits are presented below.

(Dollars in thousands)	**December 31, 2018**
2019	$ 108,363
2020	28,888
2021	16,630
2022	20,966
2023	6,390
Total certificates of deposit and other time deposits	$ 181,237

Additionally, at December 31, 2018 and 2017, approximately $59.4 million and $55.2 million, respectively, of certificates of deposit and other time deposits were issued in denominations of $250 thousand or greater.

At December 31, 2018 and 2017, the amount of deposit accounts in overdraft status that were reclassified to loans on the accompanying consolidated balance sheets was not material.

NOTE 9: SHORT-TERM BORROWINGS

At December 31, 2018 and 2017, the composition of short-term borrowings is presented below.

	2018		**2017**	
(Dollars in thousands)	**Amount**	**Weighted Avg. Rate**	**Amount**	**Weighted Avg. Rate**
Federal funds purchased:				
As of December 31	$ —	—	$ —	—
Average during the year	2	2.50 %	9	2.01 %
Maximum outstanding at any month-end	—		—	
Securities sold under agreements to repurchase:				
As of December 31	$ 2,300	0.50 %	$ 2,658	0.50 %
Average during the year	2,632	0.50 %	3,467	0.52 %
Maximum outstanding at any month-end	3,241		4,152	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling $41.0 million with none outstanding at December 31, 2018.

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 $5.6 million and $5.8 million at December 31, 2018 and 2017, respectively, were pledged to secure securities sold under agreements to repurchase.

NOTE 10: LONG-TERM DEBT

At December 31, 2018 and 2017, the composition of long-term debt is presented below.

	2018		2017	
(Dollars in thousands)	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
Subordinated debentures, due 2033	$ —	— %	$ 3,217	4.63%
Total long-term debt	$ —	— %	$ 3,217	4.63%

The Company formed Auburn National Bancorporation Capital Trust I (the "Trust"), 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 held, were used to purchase junior 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 would have matured on December 31, 2033 and had been redeemable since December 31, 2008.

On April 27, 2018, the Trust formally redeemed all of its issued and outstanding trust preferred securities at par. The Company had repurchased $4.0 million par amount of trust preferred securities issued by the Trust in October 2016, at a discount. The additional amount paid on April 27, 2018 for trust preferred securities not previously purchased by the Company was approximately $3.0 million, including accrued and unpaid distributions. All junior subordinated debentures related to the Trust were redeemed and retired as a result of the action.

The Company now has no outstanding trust preferred securities or junior subordinated debentures, and the Trust has been dissolved.

NOTE 11: 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 (loss) income. Other comprehensive (loss) income for the years ended December 31, 2018 and 2017, is presented below.

(In thousands)	Pre-tax amount	Tax benefit (expense)	Net of tax amount
2018:			
Unrealized net holding loss on all other securities	$ (4,269)	1,072	(3,197)
Other comprehensive loss	$ (4,269)	1,072	(3,197)
2017:			
Unrealized net holding gain on all other securities	$ 417	(154)	263
Reclassification adjustment for net gain on securities recognized in net earnings	(51)	19	(32)
Other comprehensive income	$ 366	(135)	231

NOTE 12: INCOME TAXES

For the years ended December 31, 2018 and 2017 the components of income tax expense from continuing operations are presented below.

(Dollars in thousands)		Year ended December 31 2018	2017
Current income tax expense:			
Federal	$	1,685	2,782
State		431	499
Total current income tax expense		2,116	3,281
Deferred income tax expense (benefit):			
Federal		56	384
State		15	(28)
Total deferred income tax expense		71	356
Total income tax expense	$	2,187	3,637

Total income tax expense differs from the amounts computed by applying the statutory federal income tax rate of 21% and 34% for the years ended December 31, 2018 and 2017, respectively, to earnings before income taxes. A reconciliation of the differences for the years ended December 31, 2018 and 2017, is presented below.

		2018		2017	
(Dollars in thousands)		Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings
Earnings before income taxes	$	11,021		11,483	
Income taxes at statutory rate		2,315	21.0 %	3,904	34.0 %
Tax-exempt interest		(515)	(4.7)	(813)	(7.0)
State income taxes, net of federal tax effect		361	3.3	325	2.8
Bank-owned life insurance		(92)	(0.8)	(150)	(1.3)
Federal tax reform impact		—	—	370	3.2
Other		118	1.0	1	—
Total income tax expense	$	2,187	19.8 %	3,637	31.7 %

The Tax Cuts and Jobs Act was signed into law on December 22, 2017. The net tax expense recognized as a result of the remeasurement of deferred taxes is presented as Federal tax reform impact in the above table.

The Company had net deferred tax assets of $1.8 million and $0.8 million at December 31, 2018 and 2017, 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, 2018 and 2017 are presented below:

		December 31	
(Dollars in thousands)		**2018**	**2017**
Deferred tax assets:			
Allowance for loan losses	$	1,203	1,195
Unrealized loss on securities		1,262	190
Other		135	216
Total deferred tax assets		2,600	1,601
Deferred tax liabilities:			
Premises and equipment		280	241
Originated mortgage servicing rights		362	413
Other		168	158
Total deferred tax liabilities		810	812
Net deferred tax asset	$	1,790	789

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, 2018. 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, 2018 and 2017, is presented below.

		Year ended December 31	
(Dollars in thousands)		**2018**	**2017**
Net deferred tax asset:			
Balance, beginning of year	$	789	1,280
Deferred tax expense related to continuing operations		(71)	(356)
Stockholders' equity, for accumulated other comprehensive loss (income)		1,072	(135)
Balance, end of year	$	1,790	789

ASC 740, *Income Taxes,* 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, 2018, 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 2019 relative to any tax positions taken prior to December 31, 2018. As of December 31, 2018, 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, 2015 through 2018.

NOTE 13: 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 $131 thousand and $127 thousand for the years ended December 31, 2018 and 2017, respectively, and are included in salaries and benefits expense.

NOTE 14: 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, 2018 and December 31, 2017, 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.

The Company had no interest rate swaps as of December 31, 2018. A summary of the Company's interest rate swaps as of and for the year ended December 31, 2017 is presented below.

		Other Assets	Other Liabilities	Other noninterest income
(Dollars in thousands)	Notional	Estimated Fair Value	Estimated Fair Value	Gains (Losses)
December 31, 2017:				
Pay fixed / receive variable	$ 3,617	—	52	$ 189
Pay variable / receive fixed	3,617	52	—	(189)
Total interest rate swap agreements	$ 7,234	52	52	$ —

NOTE 15: 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, 2018 and 2017, the following financial instruments were outstanding whose contract amount represents credit risk:

	December 31	
(Dollars in thousands)	2018	2017
Commitments to extend credit	$ 61,889	$ 57,014
Standby letters of credit	7,026	7,390

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 $73 thousand and $79 thousand at December 31, 2018 and 2017, respectively.

Other Commitments

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2018, are as follows: 2019, $152 thousand; 2020, $94 thousand; 2021, $67 thousand; 2022, $60 thousand; 2023, $60 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 effect upon the consolidated financial condition or results of operations of the Company and the Bank.

NOTE 16: 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, 2018 and 2017, 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.

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of December 31, 2018 and 2017, respectively, by caption, on the accompanying consolidated balance sheets by ASC 820 valuation hierarchy (as described above).

(Dollars in thousands)	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2018:				
Securities available-for-sale:				
Agency obligations	$ 51,171	—	51,171	—
Agency RMBS	118,598	—	118,598	—
State and political subdivisions	70,032	—	70,032	—
Total securities available-for-sale	239,801	—	239,801	—
Total assets at fair value	$ 239,801	—	239,801	—
December 31, 2017:				
Securities available-for-sale:				
Agency obligations	$ 53,062	—	53,062	—
Agency RMBS	133,072	—	133,072	—
State and political subdivisions	71,563	—	71,563	—
Total securities available-for-sale	257,697	—	257,697	—
Other assets [1]	52	—	52	—
Total assets at fair value	$ 257,749	—	257,749	—
Other liabilities[1]	52	—	52	—
Total liabilities at fair value	$ 52	—	52	—

[1]Represents the fair value of interest rate swap agreements.

Assets and liabilities measured at fair value on a nonrecurring basis

Loans held for sale

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

Impaired Loans

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

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

Other real estate owned

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

Mortgage servicing rights, net

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

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2018 and 2017, respectively, by caption, on the accompanying consolidated balance sheets and by ASC 820 valuation hierarchy (as described above):

(Dollars in thousands)		**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
December 31, 2018:					
Loans held for sale	$	383	—	383	—
Loans, net[(1)]		157	—	—	157
Other real estate owned		172	—	—	172
Other assets [(2)]		1,441	—	—	1,441
Total assets at fair value	$	2,153	—	383	1,770
December 31, 2017:					
Loans held for sale	$	1,922	—	1,922	—
Loans, net[(1)]		2,700	—	—	2,700
Other assets [(2)]		1,644	—	—	1,644
Total assets at fair value	$	6,266	—	1,922	4,344

[(1)]Loans considered impaired under ASC 310-10-35 Receivables. This amount reflects the recorded investment in impaired loans, net of any related allowance for loan losses.
[(2)]Represents MSRs, net, carried at lower of cost or estimated fair value.

At December 31, 2018 and 2017 and for the years then ended, the Company had no Level 3 assets measured at fair value on a recurring basis. For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2018, the significant unobservable inputs used in the fair value measurements are presented below.

(Dollars in thousands)		**Carrying Amount**	**Valuation Technique**	**Significant Unobservable Input**	**Weighted Average of Input**
Nonrecurring:					
Impaired loans	$	157	Appraisal	Appraisal discounts (%)	10.0%
Other real estate owned		172	Appraisal	Appraisal discounts (%)	10.0%
Mortgage servicing rights, net		1,441	Discounted cash flow	Prepayment speed or CPR (%)	8.3%
				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. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of December 31, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

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 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, 2018 and 2017 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.

			Fair Value Hierarchy		
(Dollars in thousands)	**Carrying amount**	**Estimated fair value**	**Level 1 inputs**	**Level 2 inputs**	**Level 3 Inputs**
December 31, 2018:					
Financial Assets:					
Loans, net (1)	$ 472,118	$ 465,456	$ —	$ —	$ 465,456
Loans held for sale	383	397	—	397	—
Financial Liabilities:					
Time Deposits	$ 181,237	$ 181,168	$ —	$ 181,168	$ —
December 31, 2017:					
Financial Assets:					
Loans, net (1)	$ 448,894	$ 447,468	$ —	$ —	$ 447,468
Loans held for sale	1,922	1,950	—	1,950	—
Financial Liabilities:					
Time Deposits	$ 188,071	$ 185,564	$ —	$ 185,564	$ —
Long-term debt	3,217	3,217	—	3,217	—

(1) Represents loans, net of unearned income and the allowance for loan losses. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of December 31, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

NOTE 17: RELATED PARTY TRANSACTIONS

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.

(Dollars in thousands)		**Amount**
Loans outstanding at December 31, 2017	$	3,068
New loans/advances		5,871
Repayments		(732)
Loans outstanding at December 31, 2018	$	8,207

During 2018 and 2017, 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, 2018 and 2017 amounted to $19.8 million and $17.8 million, respectively.

NOTE 18: REGULATORY RESTRICTIONS AND CAPITAL RATIOS

As required by the Economic Growth, Regulatory Relief, and Consumer Protection Act in August 2018, the Federal Reserve Board issued an interim final rule that expanded applicability of the Board's small bank holding company policy statement. The interim final rule raised the policy statement's asset threshold from $1 billion to $3 billion in total consolidated assets for a bank holding company or savings and loan holding company that: (1) is not engaged in significant nonbanking activities; (2) does not conduct significant off-balance sheet activities; and (3) does not have a material amount of debt or equity securities, other than trust-preferred securities, outstanding. The interim final rule provides that, if warranted for supervisory purposes, the Federal Reserve may exclude a company from the threshold increase. Management believes the Company meets the conditions of the Federal Reserve's small bank holding company policy statement and is therefore excluded from consolidated capital requirements at December 31, 2018.

The Bank remains subject to regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

As of December 31, 2018, the Bank is "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Bank must maintain minimum common equity Tier 1, total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. Management has not received any notification from 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, 2018 and 2017 are presented below.

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized	
(Dollars in thousands)	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
At December 31, 2018:						
Tier 1 Leverage Capital						
AuburnBank	$ 91,719	11.33 %	$ 32,368	4.00 %	$ 40,461	5.00 %
Common Equity Tier 1 Capital						
AuburnBank	$ 91,719	16.49 %	$ 25,031	4.50 %	$ 36,156	6.50 %
Tier 1 Risk-Based Capital						
AuburnBank	$ 91,719	16.49 %	$ 33,375	6.00 %	$ 44,500	8.00 %
Total Risk-Based Capital						
AuburnBank	$ 96,661	17.38 %	$ 44,500	8.00 %	$ 55,625	10.00 %
At December 31, 2017:						
Tier 1 Leverage Capital						
Auburn National Bancorporation	$ 90,382	10.95 %	$ 33,012	4.00 %	N/A	N/A
AuburnBank	89,217	10.82	32,978	4.00	$ 41,222	5.00 %
Common Equity Tier 1 Capital						
Auburn National Bancorporation	$ 87,382	16.42 %	$ 23,949	4.50 %	N/A	N/A
AuburnBank	89,217	16.74	23,987	4.50	$ 34,648	6.50 %
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	$ 90,382	16.98 %	$ 31,932	6.00 %	N/A	N/A
AuburnBank	89,217	16.74	31,983	6.00	$ 42,644	8.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	$ 95,300	17.91 %	$ 42,576	8.00 %	N/A	N/A
AuburnBank	94,135	17.66	42,644	8.00	$ 53,305	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, 2018, the Bank could have declared additional dividends of approximately $8.0 million without prior approval of regulatory authorities. As a result of this limitation, approximately $79.9 million of the Company's investment in the Bank was restricted from transfer in the form of dividends.

NOTE 19: 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

		December 31	
(Dollars in thousands)		2018	2017
Assets:			
Cash and due from banks	$	1,941	1,170
Investment in bank subsidiary		87,956	88,741
Other assets		626	1,760
Total assets	$	90,523	91,671
Liabilities:			
Accrued expenses and other liabilities	$	1,468	1,548
Long-term debt		—	3,217
Total liabilities		1,468	4,765
Stockholders' equity		89,055	86,906
Total liabilities and stockholders' equity	$	90,523	91,671

CONDENSED STATEMENTS OF EARNINGS

		Year ended December 31	
(Dollars in thousands)		2018	2017
Income:			
Dividends from bank subsidiary	$	6,533	3,471
Noninterest income		149	141
Total income		6,682	3,612
Expense:			
Interest expense		51	125
Noninterest expense		237	225
Total expense		288	350
Earnings before income tax benefit and equity in undistributed earnings of bank subsidiary		6,394	3,262
Income tax benefit		(28)	(58)
Earnings before equity in undistributed earnings of bank subsidiary		6,422	3,320
Equity in undistributed earnings of bank subsidiary		2,412	4,526
Net earnings	$	8,834	7,846

CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)		Year ended December 31 2018	2017
Cash flows from operating activities:			
Net earnings	$	8,834	7,846
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Net decrease (increase) in other assets		1,134	(879)
Net decrease in other liabilities		(70)	(109)
Equity in undistributed earnings of bank subsidiary		(2,412)	(4,526)
Net cash provided by operating activities		7,486	2,332
Cash flows from financing activities:			
Repayments or retirement of long-term debt		(3,217)	—
Dividends paid		(3,498)	(3,352)
Net cash used in financing activities		(6,715)	(3,352)
Net change in cash and cash equivalents		771	(1,020)
Cash and cash equivalents at beginning of period		1,170	2,190
Cash and cash equivalents at end of period	$	1,941	1,170

NOTE 20: REVENUE RECOGNITION

On January 1, 2018, the Company implemented ASU 2014-09, *Revenue from Contracts with Customers*, codified at *ASC* 606. The Company adopted ASC 606 using the modified retrospective transition method. As of December 31, 2017, the Company had no uncompleted customer contracts and, as a result, no cumulative transition adjustment was made to the Company's accumulated deficit during the year ended December 31, 2018. Results for reporting periods beginning January 1, 2018 are presented under ASC 606, while prior period amounts continue to be reported under legacy U.S. GAAP.

The majority of the Company's revenue stream is generated from interest income on loans and deposits which are outside the scope of ASC 606.

The Company's sources of income that fall within the scope of Topic 606 include service charges on deposits, investment services, interchange fees and gains and losses on sales of other real estate, all of which are presented as components of noninterest income. The following is a summary of the revenue streams that fall within the scope of Topic 606:

- Service charges on deposits, investment services, ATM and interchange fees – Fees from these services are either transaction-based, for which the performance obligations are satisfied when the individual transaction is processed, or set periodic service charges, for which the performance obligations are satisfied over the period the service is provided. Transaction-based fees are recognized at the time the transaction is processed, and periodic service charges are recognized over the service period.

- *Gains on sales of other real estate* – ASU 2014-09 creates Topic 610-20, under which a gain on sale should be recognized when a contract for sale exists and control of the asset has been transferred to the buyer. Topic 606 lists several criteria required to conclude that a contract for sale exists, including a determination that the institution will collect substantially all of the consideration to which it is entitled. This presents a key difference between the prior and new guidance related to the recognition of the gain when the institution finances the sale of the property. Rather than basing recognition on the amount of the buyer's initial investment, which was the primary consideration under prior guidance, the analysis is now based on various factors including not only the loan to value, but also the credit quality of the borrower, the structure of the loan, and any other factors that may affect collectability.

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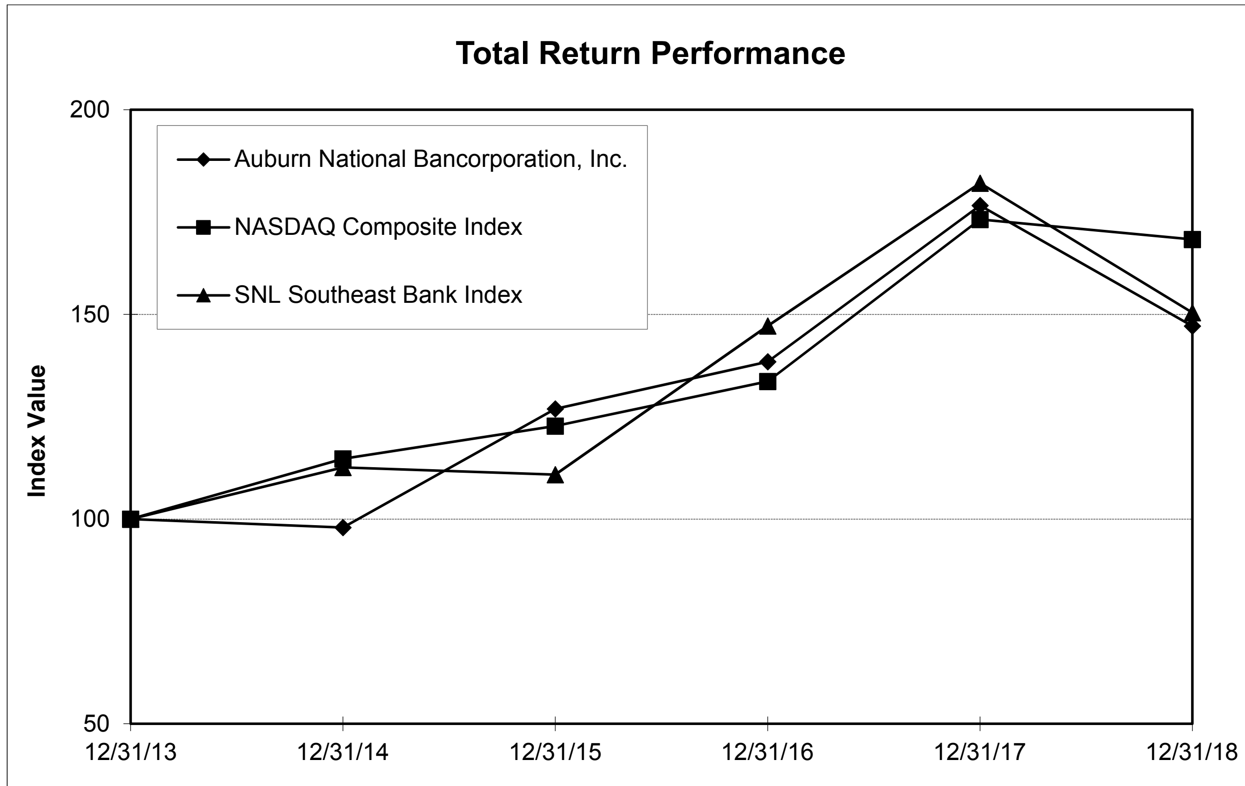
Stock Performance Graph

The following performance graph compares the cumulative, total return on the Company's Common Stock from December 31, 2013 to December 31, 2018, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a $100 investment on December 31, 2013). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.



	Period Ending					
Index	**12/31/13**	**12/31/14**	**12/31/15**	**12/31/16**	**12/31/17**	**12/31/18**
Auburn National Bancorporation, Inc.	100.00	97.93	126.92	138.44	176.60	147.15
NASDAQ Composite	100.00	114.75	122.74	133.62	173.22	168.30
SNL Southeast Bank	100.00	112.63	110.87	147.18	182.06	150.42

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

INDEPENDENT AUDITORS

Elliott Davis LLC/PLLC
200 East Broad Street
Greenville, SC 29606

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 505000
Louisville, KY 40233
Phone: 1-800-368-5948

For frequently asked questions,
visit theTransfer Agent's home page at:
www.computershare.com

ANNUAL MEETING

Tuesday, May 14, 2019
3:00 p.m. (Central Time)
AuburnBank Center
132 N. Gay Street
Auburn, AL 36830

INVESTOR RELATIONS

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

COMMON STOCK LISTING

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

DIVIDEND REINVESTMENT AND STOCK PURCHASE PLAN

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

DIRECT DEPOSIT OF DIVIDENDS

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

100 N. Gay Street, P.O. Box 3110, Auburn, AL 36831-3110
Telephone: 334-821-9200 Fax: 334-887-2796

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