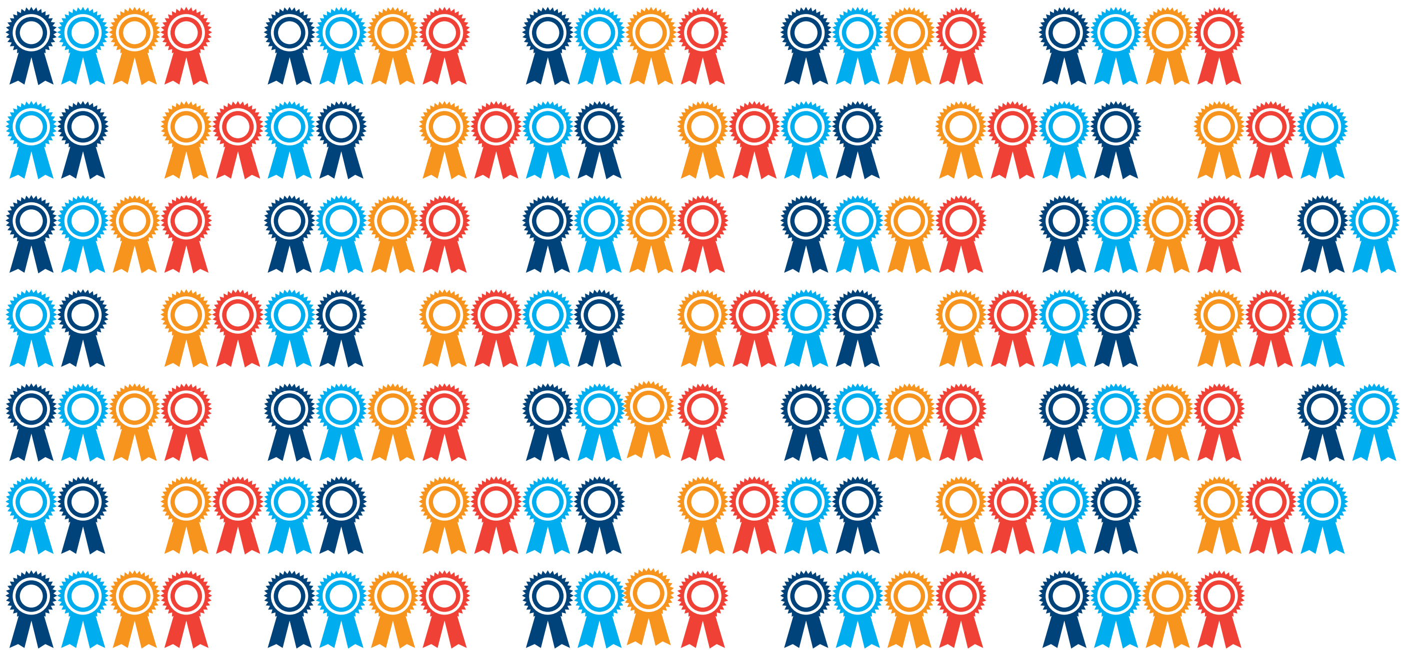
Auburn National Bancorporation, Inc.

2019 Annual Report



Champions of You

Auburn National Bancorporation, Inc.

2019 Annual Report

AUBURNBANK

To Our Shareholders and Friends,

I am pleased to report that 2019 was a record year for our Bank. Earnings of $9.7MM produced earnings per share of $2.72 and a return on average assets of 1.18%. We continue to maintain a strong capital position along with very stable asset quality.

While we expect a challenging interest rate and competitive environment in 2020, economic conditions in our markets remain robust, and we are optimistic that credit quality will continue to be relatively strong in 2020. Regardless of the operating environment, we are confident that our long-term approach and philosophy of knowing and being champions for our customers, maintaining exceptional asset quality, and supporting our communities will enable us to continue to generate value for our shareholders in 2020 and beyond.

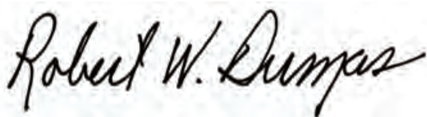
I believe the next decade will bring continued technological innovations that will be beneficial to all of our customers. From an easier and more secure way of transferring funds to the delivery of new products and services, I'm excited to see where technology takes us. Of course, security and protection of your information will be our highest priority.

We know that the community and the people who live here are why we exist. That's been true for over 100 years. We work tirelessly to be there for whatever financial needs you may have, and we are honored to be a big part of the well-being and growth of our community. Our main vision and goal is to be "Champions of You."

It's a statement that represents our commitment to you and what our mentality has always been at AuburnBank, and the mentality we'll continue to have as we grow together.

This commitment coupled with top-quality service and the protection of your financial data and information is critical to your success and ours.

Thank you for your continued support as we enter the next decade with excitement and enthusiasm.



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

Let’s face it. When you’re 113 years old like we are, it’s a good feeling to wake up in the morning and realize there’s still so much more we can do.

Last year was a record year for AuburnBank, and in 2020, we’ll continue to focus on better serving you and our growing communities’ needs.

This means better tools, better service, and an even higher level of engagement. As today’s banking and lending landscape continues to rapidly evolve, it’s incumbent upon us to stay ahead of the curve. That’s why giving our customers better tools that extend beyond the walls of our bank branches is a top priority that allows you more flexibility to bank when you want and how you want.

2020 will be the year the mortgage application process moves from the banker's desk to the kitchen table. Of course, we're still keeping the desks (and all your favorite loan officers that sit behind them), but now we're making it easier for future homeowners to apply for a mortgage from anywhere they choose by simply visiting AuburnBank.com and applying online.

Also in 2020, we're working towards a new partnership with the digital payments network, Zelle, allowing customers to quickly and safely transfer money from person to person using their mobile devices. Best of all, AuburnBank customers will be able to sign up for the service directly through our mobile banking app. So whether it's splitting the check at dinner, or paying your landscaper for shaping a War Eagle out of your hedges, transferring money will soon be more convenient.

It's not just our technology that's looking toward the future. Our headquarters are also getting a major remodel. As part of our continuing investment in downtown Auburn, our home for the past 113 years, we'll be breaking ground on a new 96,000 square foot state-of-the-art banking and mixed-use facility, as well as a five-story parking deck. The new facility will be located at the corner of East Magnolia and Gay, pulling operations and retail banking under one roof. With upgraded technological capabilities and a convenient location, we'll be proud to call this new facility home for many decades to come.

#1
Deposit Market Share
Position in Lee County

Top 200
Publicly Traded
Community Bank

The Opelika-Auburn News
Bank and Best
Mortgage Lender

Speaking of a fresh coat of paint, AuburnBank is also getting a marketing and brand identity upgrade. That means an updated logo, an updated tagline, updated brand guidelines, and a brand new ad campaign on their way soon. Why the update? It's simple. We wanted to better reflect our commitment to the growth of our customers and the communities we live in. And it's no secret that this region is one of the fastest-growing metropolitan areas in Alabama, with new residents arriving every day.

You have known us for years as "your partner, your neighbor, your friend." But what about those who weren't familiar with us or were new to the region? Or those looking for a flexible banking option that was both future-focused and customer-centric?

One of our best attributes has always been our strong relationship with you, our customer. We grew up with you. We helped you buy your first house, or your second house when the kids came along. And then the third when your kids went off to college. Through our relationships and our products, we've always championed our customers' goals. That's why we're excited to share our new tagline—Champions of You.

"Champions of You" moves us away from talking about ourselves, and puts our customers and all their hopes and dreams at the center of AuburnBank's universe, right where they've always been, and right where they'll always be.

Lastly, but most importantly, in 2020, we will continue our efforts to be supportive and worthy neighbors to the people and the communities we serve. For us, giving back and helping others is not a part of what we do, but is the very core of who we are. You're just as likely to see us out in the community volunteering or helping others as you are to see us standing behind a teller window. Because without our communities, there is no AuburnBank.

So whether it's an employee-led effort raising tens of thousands of dollars for the United Way of Lee County, or sponsoring LifeSouth blood drives at which we match donations with dollars to go to charities like the Food Bank of East Alabama, the communities we serve are filled with our neighbors. And neighbors look out for one another.

That is why we plan to champion you proudly for the next 113 years.

United Way Leadership in Business Award

Seated left to right: David E. Housel, Robert W. Dumas, Dr. Patricia Wade
Standing: J. Tutt Barrett, Terry W. Andrus, E. L. Spencer, III, and William F. Ham, Jr.
Not pictured: C. Wayne Alderman and Anne M. May

Auburn National Bancorporation, Inc. and AuburnBank Board of Directors

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

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

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

E. L. Spencer, III
Investor

Dr. Patricia Wade
Retired Physician,
Pinnacle Cardiovascular
Associates

Opelika Branch Advisory Board

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.

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

Valley Branch Advisory Board

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

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

AuburnBank Officers

Robert W. Dumas
Chairman, President
& Chief Executive Officer

David Hedges
Executive Vice President,
Chief Financial 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

W. Thomas Johnson
Senior Vice President,
Senior Lender

Marla Kickliter
Senior Vice President,
Compliance & Internal
Auditor

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

Christy Fogle
Vice President,
Credit Administration

Pam Fuller
Senior Vice President,
Operations

April Herring
Vice President,
Mortgage Division Manager

Ginnie Y. Lunsford
Vice President,
Loan Operations

Marcia Otwell
Vice President, Admin/
Shareholder Relations

James R. Pack
Vice President,
Financial Reporting

Greg Pettey
Vice President,
Commercial/Consumer
Loans

Cyndee Redmond
Vice President,
Business Systems Analysis

Jeff Stanfield
Vice President,
Commercial/Consumer
Loans

David Warren
Senior Vice President,
Commercial/Consumer
Loans

Karen Bence
Assistant Vice President,
Security, BSA/OFAC Officer

Suzanne Gibson
Assistant Vice President,
Portfolio Management
Officer

Woody Odom
Assistant Vice President
IT/IS

Cindy Royster
Assistant Vice President,
Branch Administation & IRA
Specialist

Joanna Watts
Assistant Vice President,
IT/IS

Rhonda Sanders
Deposit Operations,
Customer Identification
Program Officer

Leigh Ann Thompson
Data Analytics Officer

Latoya Watts
Branch Administrator,
Training Officer

Hope Woods
Assistant BSA Officer,
Assistant Security Officer

Auburn National Bancorporation, Inc.

Financial Highlights

(Dollars in thousands, except per share data)

	For the Years Ended December 31,				
	2019	2018	2017	2016	2015
Earnings					
Net Interest Income	$26,064	$25,570	$24,526	$22,732	$22,718
Provision for Loan Losses	<250>	——	<300>	<485>	200
Net Earnings	9,741	8,834	7,846	8,150	7,858
Per Share:					
Net Earnings	2.72	2.42	2.15	2.24	2.16
Cash Dividends	1.00	0.96	0.92	0.90	0.88
Book Value	27.57	24.44	23.85	22.55	21.94
Shares Issued	3,957,135	3,957,135	3,957,135	3,957,135	3,957,135
Weighted Average Shares Outstanding	3,581,476	3,643,780	3,643,616	3,643,504	3,643,428
Financial Condition					
Total Assets	828,570	818,077	853,381	831,943	817,189
Loans, net of unearned income	460,901	476,908	453,651	430,946	426,410
Investment Securities	235,902	239,801	257,697	243,572	241,687
Total Deposits	724,152	724,193	757,659	739,143	723,627
Long Term Debt	——	——	3,217	3,217	7,217
Stockholder' Equity	98,328	89,055	86,906	82,177	79,949
Selected Ratios					
Return on Average Total Assets	1.18%	1.08%	0.94%	0.98%	0.98%
Return on Average Total Equity	10.35%	10.14%	9.17%	9.65	9.98%
Average Stockholders' Equity to Average Assets	11.39%	10.63%	10.35%	10.14%	9.79%
Allowance for Loan Losses as a % of Loans	0.95%	1.00%	1.05%	1.08%	1.01%
Loans to Total Deposits	63.65%	65.85%	59.88%	58.30%	58.93%

Financial Section

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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, foreign, domestic and locally, including seasonality, including as a result of natural disasters or climate change, such as rising sea and water levels, hurricanes and tornados, coronavirus or other epidemics or pandemics; (ii) the effects of war or other conflicts, acts of terrorism, or other events that may affect general economic conditions; (iii) governmental monetary and fiscal policies; (iv) 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; (v) 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 reviews; (vi) 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; (vii) changes in borrower credit risks and payment behaviors; (viii) 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; (ix) changes in the prices, values and sales volumes of residential and commercial real estate; (x) 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; (xi) 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; (xii) the costs of redeveloping our headquarters and the timing and amount of rental income upon completion of the project; (xiii) 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; (xiv) changes in technology or products that may be more difficult, costly, or less effective than anticipated; (xv) cyber-attacks and data breaches that may compromise our systems, our vendor systems or customers' information; (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 our 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, 2019 and 2018 and our results of operations for the years ended December 31, 2019 and 2018. 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 loan production offices in Auburn and Phenix City, Alabama.

Summary of Results of Operations

	Year ended December 31	
(Dollars in thousands, except per share data)	**2019**	**2018**
Net interest income (a)	$ 26,621	$ 26,183
Less: tax-equivalent adjustment	557	613
Net interest income (GAAP)	26,064	25,570
Noninterest income	5,494	3,325
Total revenue	31,558	28,895
Provision for loan losses	(250)	—
Noninterest expense	19,697	17,874
Income tax expense	2,370	2,187
Net earnings	$ 9,741	$ 8,834
Basic and diluted net earnings per share	$ 2.72	$ 2.42

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

Financial Summary

The Company's net earnings were $9.7 million for the full year 2019, compared to $8.8 million for the full year 2018. Basic and diluted net earnings per share were $2.72 per share for the full year 2019, compared to $2.42 per share for the full year 2018.

Net interest income (tax-equivalent) was $26.6 million in 2019, a 2% increase compared to $26.2 million in 2018. This increase was primarily due to loan growth and increases in short-term market interest rates. Average loans grew 4% to $474.3 million in 2019, compared to $456.3 million in 2018. The Company's net interest margin (tax-equivalent) increased to 3.43% in 2019, compared to 3.40% in 2018 as yields on earning assets improved.

The Company recorded a negative provision for loan losses of $0.3 million in 2019 compared to no provision for loan losses during 2018. 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 charge-offs as a percent of average loans were 0.03% in 2019 compared to annualized net recoveries of 0.01% in 2018.

Noninterest income was $5.5 million in 2019 compared to $3.3 million in 2018. The increase was primarily due to a $1.7 million payment received by the Company that resulted from the termination of a loan guarantee program operated by the State of Alabama and a $0.3 million pre-tax gain from an insurance recovery received in the first quarter of 2019. Mortgage lending income also increased $0.2 million, or 32%, as pricing margins improved and lower interest rates for mortgage loans positively affected refinance activity.

Noninterest expense was $19.7 million in 2019 compared to $17.9 million in 2018. This increase in noninterest expense was primarily due to increases in salaries and benefits expense of $1.3 million and $0.5 million of various expenses related to the planned redevelopment of the Company's headquarters in downtown Auburn, including professional fees, temporary relocation costs, and revised depreciation estimates. The Company expects it will incur additional expense in 2020 related to this redevelopment project.

Income tax expense was $2.4 million in 2019 and $2.2 million in 2018 reflecting an effective tax rate of 19.57% and 19.84%, respectively.

The Company paid cash dividends of $1.00 per share in 2019, an increase of 4.2% from 2018. At December 31, 2019, 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 19.69%, a tier 1 leverage ratio of 11.23% and common equity tier 1 ("CET1") of 18.78% at December 31, 2019.

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, 2019 and 2018, 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, 2019, the Company increased its look-back period to 43 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 15, 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, 2019. 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					
	2019			2018		
		Average	Yield/		Average	Yield/
(Dollars in thousands)		Balance	Rate		Balance	Rate
Loans and loans held for sale	$	474,259	4.83%	$	457,610	4.76%
Securities – taxable		178,410	2.24%		181,485	2.23%
Securities - tax-exempt (a)		66,628	3.99%		71,065	4.11%
Total securities		245,038	2.72%		252,550	2.76%
Federal funds sold		20,223	2.09%		28,689	1.93%
Interest bearing bank deposits		36,869	2.16%		31,339	1.81%
Total interest-earning assets		776,389	3.97%		770,188	3.88%
Deposits:						
NOW		134,430	0.53%		125,533	0.34%
Savings and money market		218,630	0.44%		220,810	0.39%
Certificates of deposits		170,835	1.46%		184,010	1.27%
Total interest-bearing deposits		523,895	0.80%		530,353	0.68%
Short-term borrowings		1,443	0.49%		2,634	0.68%
Long-term debt		—	0.00%		1,022	4.50%
Total interest-bearing liabilities		525,338	0.80%		534,009	0.69%
Net interest income and margin (a)	$	26,621	3.43%	$	26,183	3.40%

(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 $26.6 million in 2019, compared to $26.2 million in 2018. This increase was due to improvement in the Company's net interest margin (tax-equivalent) and balance sheet growth.

The tax-equivalent yield on total interest-earning assets increased by 9 basis points in 2019 from 2018 to 3.97%. Expansion of our earning asset yields was primarily driven by loan growth and 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.

The cost of total interest-bearing liabilities increased 11 basis points in 2019 from 2018 to 0.80%. 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, increased competition for quality loan opportunities, and possible increases in our costs of funds. Management anticipates the Company's net interest income and margin will likely decrease in 2020 compared to 2019 as the Company's ability to lower its deposit costs will likely continue to lag the current decrease in earning asset yields.

Provision for Loan Losses

The Company recorded a negative provision for loan losses of $0.3 million in 2019, compared to no provision for loan losses in 2018. The negative provision was primarily related to a decline in total loans outstanding at December 31, 2019 and more specifically the construction and land development loan portfolio segment.

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 0.95% at December 31, 2019 from 1.00% at December 31, 2018. 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, 2019. 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)	**2019**	**2018**
Service charges on deposit accounts	$ 717	$ 749
Mortgage lending	866	655
Bank-owned life insurance	437	435
Gain from loan guarantee program	1,717	—
Securities losses, net	(123)	—
Other	1,880	1,486
Total noninterest income	$ 5,494	$ 3,325

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 2019 and 2018.

	Year ended December 31	
(Dollars in thousands)	**2019**	**2018**
Origination income	$ 545	$ 311
Servicing fees, net	321	344
Total mortgage lending income	$ 866	$ 655

The increase in mortgage lending income was primarily due to improved pricing margins and an increase in the level of refinance activity. The Company's income from mortgage lending typically fluctuates as mortgage interest rates change and is primarily attributable to the origination and sale of new mortgage loans.

In 2019, the Company recognized a gain of $1.7 million resulting from the termination of a Loan Guarantee Program (the "Program") operated by the State of Alabama. For more information regarding the Program, please refer to Note 5, Loans and Allowance for Loan Losses, of the consolidated financial statements that accompany this report.

The increase in other noninterest income was primarily due to a $0.3 million gain from an insurance recovery received in the first quarter of 2019.

Noninterest Expense

(Dollars in thousands)	Year ended December 31 2019		2018	
Salaries and benefits	$	11,931	$	10,653
Net occupancy and equipment		1,907		1,465
Professional fees		1,014		902
FDIC and other regulatory assessments		181		310
Other		4,664		4,544
Total noninterest expense	$	19,697	$	17,874

The increase in salaries and benefits expense in 2019 over 2018 was due to a variety of factors, including an increase in the number of employees, routine annual wage increases, incentive accrual increases, an increase in the employer matching contribution percentage under the Company's 401(k) Plan, and an increase in severance pay.

The increase in net occupancy and equipment expense and professional fees expense was primarily due to $0.5 million of various expenses related to the planned redevelopment of the Company's headquarters in downtown Auburn. This amount includes revised depreciation estimates of $0.2 million. For more information regarding changes in accounting estimates, please refer to Note 1, Summary of Significant Accounting Policies, of the consolidated financial statements that accompany this report.

The decrease in FDIC and other regulatory assessments expense was primarily due to the Bank receiving an assessment credit of approximately $0.2 million to offset future assessments in connection with the FDIC Deposit Insurance Fund exceeding its target ratio of 1.35% as of September 30, 2018. The Deposit Insurance Fund ratio was 1.36% at December 31, 2018, below the 1.38% threshold required for assessment credits to be applied. The Deposit Insurance Fund ratio was again below 1.38% at June 30, 2019, so assessment credit were applied against our assessment due for the third and fourth quarters of 2019. Future expense may continue to be reduced by these assessment credits depending on the level of the Deposit Insurance Fund, until they are fully utilized.

Income Tax Expense

Income tax expense was $2.4 million in 2019 compared to $2.2 million in 2018. The Company's effective income tax rate was 19.57% in 2019, compared to 19.84% in 2018.

BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale were $235.9 million at December 31, 2019, a decrease of $3.9 million, or 2%, compared to $239.8 million as of December 31, 2018. This decline was primarily due to a decrease of $11.7 million in the amortized cost basis of securities available-for-sale as proceeds from sales, calls, and maturities were not reinvested. This decrease was offset by an increase in the fair value of securities available-for-sale of $7.8 million. The average tax-equivalent yields earned on total securities were 2.72% in 2019 and 2.76% in 2018.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2019 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, 2019
(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Total Fair Value
Agency obligations	$ 4,993	27,245	18,470	—	50,708
Agency RMBS	—	560	4,510	118,207	123,277
State and political subdivisions	—	1,355	6,166	54,396	61,917
Total available-for-sale	$ 4,993	29,160	29,146	172,603	235,902
Weighted average yield:					
Agency obligations	1.63%	1.78%	2.26%	—	1.94%
Agency RMBS	—	3.42%	2.50%	2.64%	2.63%
State and political subdivisions	—	4.06%	2.32%	3.07%	3.01%
Total available-for-sale	1.63%	1.92%	2.31%	2.77%	2.58%

Loans

					December 31
(In thousands)	2019	2018	2017	2016	2015
Commercial and industrial	$ 56,782	63,467	59,086	49,850	52,479
Construction and land development	32,841	40,222	39,607	41,650	43,694
Commercial real estate	270,318	261,896	239,033	220,439	203,853
Residential real estate	92,575	102,597	106,863	110,855	116,673
Consumer installment	8,866	9,295	9,588	8,712	10,220
Total loans	461,382	477,477	454,177	431,506	426,919
Less: unearned income	(481)	(569)	(526)	(560)	(509)
Loans, net of unearned income	$ 460,901	476,908	453,651	430,946	426,410

Total loans, net of unearned income, were $460.9 million at December 31, 2019, a decrease of $16.0 million, or 3%, from $476.9 million at December 31, 2018. Four loan categories represented the majority of the loan portfolio at December 31, 2019: commercial real estate mortgage loans (59%), residential real estate mortgage loans (20%), commercial and industrial loans (12%) and construction and land development loans (7%). Approximately 23% of the Company's commercial real estate loans were classified as owner-occupied at December 31, 2019.

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately $10.8 million, or 2%, and $12.3 million, or 3%, of total loans, net of unearned income at December 31, 2019 and 2018, respectively. For residential real estate mortgage loans with a consumer purpose, approximately $0.8 million and $0.5 million required interest-only payments at December 31, 2019 and 2018, respectively. The Company's residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high-risk consumer mortgage products.

Purchased loan participations included in the Company's loan portfolio were approximately $1.4 million and $5.4 million as of December 31, 2019 and 2018, 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 4.83% in 2019 and 4.76% in 2018.

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 $19.5 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of $17.5 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, 2019, 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, 2019 (and related balances at December 31, 2018).

	December 31	
(In thousands)	**2019**	**2018**
Multi-family residential properties	$ 44,839	$ 40,455
Hotel/motel	43,719	47,936
Lessors of 1-4 family residential properties	43,652	46,374
Shopping centers	30,407	35,789
Office buildings	29,548	25,421

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, 2019 and 2018, respectively, the allowance for loan losses was $4.4 million and $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, 2019 is presented below.

	Year ended December 31				
(Dollars in thousands)	**2019**	**2018**	**2017**	**2016**	**2015**
Allowance for loan losses:					
Balance at beginning of period	$ 4,790	4,757	4,643	4,289	4,836
Charge-offs:					
Commercial and industrial	(364)	(52)	(449)	(97)	(100)
Commercial real estate	—	(38)	—	(194)	(866)
Residential real estate	(6)	(26)	(107)	(182)	(89)
Consumer installment	(38)	(52)	(40)	(67)	(59)
Total charge-offs	(408)	(168)	(596)	(540)	(1,114)
Recoveries:					
Commercial and industrial	117	70	461	29	22
Construction and land development	—	—	347	1,212	17
Commercial real estate	1	19	—	—	—
Residential real estate	109	79	115	127	313
Consumer installment	27	33	87	11	15
Total recoveries	254	201	1,010	1,379	367
Net (charge-offs) recoveries	(154)	33	414	839	(747)
Provision for loan losses	(250)	—	(300)	(485)	200
Ending balance	$ 4,386	4,790	4,757	4,643	4,289
as a % of loans	0.95 %	1.00	1.05	1.08	1.01
as a % of nonperforming loans	2,345 %	2,691	160	196	158
Net charge-offs (recoveries) as a % of average loans	0.03 %	(0.01)	(0.09)	(0.19)	0.18

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 0.95% at December 31, 2019, compared to 1.00% at December 31, 2018. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken.

Net charge-offs were $0.2 million, or 0.03%, of average loans in 2019, compared to net recoveries of $33 thousand, or 0.01% of average loans, in 2018.

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, 2019 the Company had $0.2 million in nonperforming assets compared to $0.4 million at December 31, 2018.

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

(Dollars in thousands)		December 31 2019	2018	2017	2016	2015
Nonperforming assets:						
Nonperforming (nonaccrual) loans	$	187	178	2,972	2,370	2,714
Other real estate owned		—	172	—	152	252
Total nonperforming assets	$	187	350	2,972	2,522	2,966
as a % of loans and other real estate owned		0.04 %	0.07	0.66	0.59	0.70
as a % of total assets		0.02 %	0.04	0.35	0.30	0.36
Nonperforming loans as a % of total loans		0.04 %	0.04	0.66	0.55	0.64
Accruing loans 90 days or more past due	$	—	—	—	—	—

The table below provides information concerning the composition of nonaccrual loans at December 31, 2019 and 2018, respectively.

(In thousands)		December 31 2019	2018
Nonaccrual loans:			
Residential real estate		187	178
Total nonaccrual loans / nonperforming loans	$	187	178

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, 2019 and 2018, respectively, the Company had $0.2 million in loans on nonaccrual.

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, 2019 the Company had no accruing TDRs compared to $0.2 million in accruing TDRs at December 31, 2018.

At December 31, 2019 and 2018, 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, 2019 and 2018, respectively.

(In thousands)		December 31 2019	2018
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 $4.4 million, or 1.0% of total loans at December 31, 2019, compared to $6.5 million, or 1.4% of total loans at December 31, 2018.

The table below provides information concerning the composition of potential problem loans at December 31, 2019 and 2018, respectively.

(In thousands)		December 31 2019	December 31 2018
Potential problem loans:			
Commercial and industrial	$	266	522
Construction and land development		1,043	741
Commercial real estate		99	688
Residential real estate		2,899	4,506
Consumer installment		64	71
Total potential problem loans	$	4,371	6,528

At December 31, 2019, approximately $1.1 million or 26.7% 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, 2019 and 2018, respectively.

(In thousands)		December 31 2019	December 31 2018
Performing loans past due 30 to 89 days:			
Commercial and industrial	$	24	100
Construction and land development		456	225
Commercial real estate		—	—
Residential real estate		1,608	1,740
Consumer installment		64	41
Total performing loans past due 30 to 89 days	$	2,152	2,106

Deposits

(In thousands)		December 31 2019	December 31 2018
Noninterest bearing demand	$	196,218	201,648
NOW		138,315	120,769
Money market		160,934	161,464
Savings		61,486	59,075
Certificates of deposit under $100,000		59,516	62,207
Certificates of deposit and other time deposits of $100,000 or more		107,683	108,620
Brokered certificates of deposit		—	10,410
Total deposits	$	724,152	724,193

Total deposits were $724.2 million at December 31, 2019 and 2018, respectively. Decreases of $5.4 million in noninterest-bearing deposits were offset by increases in interest-bearing deposits of $5.4 million during 2019. Of the $5.4 million increase in interest-bearing deposits, $17.5 million was due to increases in NOW accounts and $2.4 million in savings accounts. These increases were partially offset by decreases of $10.4 million in brokered certificates of deposit and $3.6 million in retail certificates of deposit.

The average rates paid on total interest-bearing deposits were 0.80% in 2019 and 0.68% in 2018. Noninterest bearing deposits were 27% and 28% of total deposits at December 31, 2019 and 2018, respectively.

Other Borrowings

Other borrowings generally consist of short-term borrowings and long-term debt. Short-term borrowings generally 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, 2019 and 2018, respectively. Securities sold under agreements to repurchase totaled $1.1 million and $2.3 million at December 31, 2019 and 2018, respectively.

The average rates paid on short-term borrowings was 0.49% and 0.68% in 2019 and 2018, 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, 2019 is included in Note 9 to the accompanying consolidated financial statements included in this annual report.

The Company had no long-term debt outstanding at December 31, 2019 and 2018, respectively. On April 27, 2018, the Company formally redeemed all of the issued and outstanding junior subordinated debentures, which were previously presented as long-term debt. The average rate paid on long-term debt in 2018 was 4.50%.

CAPITAL ADEQUACY

The Company's consolidated stockholders' equity was $98.3 million and $89.1 million as of December 31, 2019 and 2018, respectively. The change from December 31, 2018 was primarily driven by net earnings of $9.7 million and other comprehensive gain due to the change in unrealized gains on securities available-for-sale, net of tax, of $5.8 million, partially offset by cash dividends paid of $3.5 million and stock repurchases of $2.7 million, representing 77,907 shares.

The Bank's Tier 1 leverage ratio was 11.23%, Common Equity Tier 1 ("CET1") risk-based capital ratio was 17.28%, Tier 1 risk-based capital ratio was 17.28%, and total risk-based capital ratio was 18.12% at December 31, 2019. 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, 2019.

Changes in Interest Rates	**Net Interest Income % Variance**
400 basis points	0.42 %
300 basis points	0.55
200 basis points	0.54
100 basis points	0.32
(100) basis points	(1.27)
(200) basis points	(1.99)
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2019, 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, 2019.

Changes in Interest Rates	EVE % Variance
400 basis points	(24.09) %
300 basis points	(16.16)
200 basis points	(9.74)
100 basis points	(3.62)
(100) basis points	(1.33)
(200) basis points	(4.08)
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2019, 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, 2019 and 2018, the Company had no derivative contracts to assist in managing interest rate sensitivity.

Liquidity Risk Management

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

Liquidity is managed at two levels. The first is the liquidity of the Company. The second is the liquidity of the Bank. The management of liquidity at both levels is essential, because the Company and the Bank are separate and distinct legal entities with different funding needs and sources, and each are subject to regulatory guidelines and requirements. The Company depends upon dividends from the Bank for liquidity to pay its operating expenses, debt obligations and dividends. The Bank's payment of dividends depends on its earnings, liquidity, capital and the absence of any regulatory restrictions.

The primary source of funding and liquidity for the Company has been dividends received from the Bank. If needed, the Company could also issue common stock or other securities. Primary uses of funds by the Company include dividends paid to stockholders and stock repurchases.

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, 2019, the Bank had a remaining available line of credit with the FHLB totaling $246.7 million. As of December 31, 2019, 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, 2019, which by their terms had contractual maturity and termination dates subsequent to December 31, 2019:

		Payments due by period				
(Dollars in thousands)		**Total**	**1 year or less**	**1 to 3 years**	**3 to 5 years**	**More than 5 years**
Contractual obligations:						
Deposit maturities (1)	$	724,152	649,693	62,075	12,384	—
Operating lease obligations		788	99	150	153	386
Total	$	724,940	649,792	62,225	12,537	386

(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, 2019, the Bank had outstanding standby letters of credit of $1.9 million and unfunded loan commitments outstanding of $60.6 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, 2019, the unpaid principal balance of residential mortgage loans, which we have originated and sold, but retained the servicing rights was $271.5 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.

The Company was not required to repurchase any loans during 2019 as a result of representation and warranty provisions contained in the Company's sale agreements with Fannie Mae. During 2018, the Company was required to repurchase one loan with an aggregate principal balance of $53 thousand that was current as to principal and interest at the time of repurchase. At December 31, 2019, the Company had no pending repurchase or make-whole 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, 2019, 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 ASUs have been issued by the FASB but are not yet effective.

- ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments;*

- 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 2016-13, *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. The Company has developed an implementation team that is following a general timeline. The team has been working with an advisory consultant, with whom a third-party software license has been purchased. 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. In November 2019, the FASB issued guidance to defer the effective dates for private companies, not-for-profit organizations, and certain smaller reporting companies applying standards on current expected credit losses. As a result of this delay, the Company's effective dated for ASU 2016-13 was delayed to fiscal year beginning after December 15, 2022 including interim periods within those fiscal years.

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 adopted this ASU on January 1, 2020. Adoption of this guidance did not have a material impact on the 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 adopted this ASU on January 1, 2020. Adoption of this guidance did not have a material impact on the 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)		**2019**	**2018**	**2017**	**2016**	**2015**
Net interest income (GAAP)	$	26,064	25,570	24,526	22,732	22,718
Tax-equivalent adjustment		557	613	1,205	1,276	1,342
Net interest income (Tax-equivalent)	$	26,621	26,183	25,731	24,008	24,060

Table 2 - Selected Financial Data

(Dollars in thousands, except per share amounts)		Year ended December 31 2019	2018	2017	2016	2015
Income statement						
Tax-equivalent interest income (a)	$	30,804	29,859	29,325	28,092	28,495
Total interest expense		4,183	3,676	3,594	4,084	4,435
Tax equivalent net interest income (a)		26,621	26,183	25,731	24,008	24,060
Provision for loan losses		(250)	—	(300)	(485)	200
Total noninterest income		5,494	3,325	3,441	3,383	4,532
Total noninterest expense		19,697	17,874	16,784	15,348	16,372
Net earnings before income taxes and tax-equivalent adjustment		12,668	11,634	12,688	12,528	12,020
Tax-equivalent adjustment		557	613	1,205	1,276	1,342
Income tax expense		2,370	2,187	3,637	3,102	2,820
Net earnings	$	9,741	8,834	7,846	8,150	7,858
Per share data:						
Basic and diluted net earnings	$	2.72	2.42	2.15	2.24	2.16
Cash dividends declared	$	1.00	0.96	0.92	0.90	0.88
Weighted average shares outstanding						
Basic and diluted		3,581,476	3,643,780	3,643,616	3,643,504	3,643,428
Shares outstanding		3,566,146	3,643,868	3,643,668	3,643,523	3,643,478
Book value	$	27.57	24.44	23.85	22.55	21.94
Common stock price						
High	$	53.90	53.50	40.25	31.31	30.39
Low		30.61	28.88	30.75	24.56	23.15
Period-end	$	53.00	31.66	38.90	31.31	29.62
To earnings ratio		19.49x	13.08	18.09	13.98	13.78
To book value		192 %	130	163	139	135
Performance ratios:						
Return on average equity		10.35 %	10.14	9.17	9.65	9.98
Return on average assets		1.18 %	1.08	0.94	0.98	0.98
Dividend payout ratio		36.76 %	39.67	42.79	40.18	40.74
Average equity to average assets		11.39 %	10.63	10.30	10.14	9.79
Asset Quality:						
Allowance for loan losses as a % of:						
Loans		0.95 %	1.00	1.05	1.08	1.01
Nonperforming loans		2,345 %	2,691	160	196	158
Nonperforming assets as a % of:						
Loans and other real estate owned		0.04 %	0.07	0.66	0.59	0.70
Total assets		0.02 %	0.04	0.35	0.30	0.36
Nonperforming loans as % of loans		0.04 %	0.04	0.66	0.55	0.64
Net charge-offs (recoveries) as a % of average loans		0.03 %	(0.01)	(0.09)	(0.19)	0.18
Capital Adequacy (c):						
CET 1 risk-based capital ratio		17.28 %	16.49	16.42	16.44	15.28
Tier 1 risk-based capital ratio		17.28 %	16.49	16.98	17.00	16.57
Total risk-based capital ratio		18.12 %	17.38	17.91	17.95	17.44
Tier 1 leverage ratio		11.23 %	11.33	10.95	10.27	10.35
Other financial data:						
Net interest margin (a)		3.43 %	3.40	3.29	3.05	3.17
Effective income tax rate		19.57 %	19.84	31.67	27.57	26.41
Efficiency ratio (b)		61.33 %	60.57	57.53	56.03	57.26
Selected period end balances:						
Securities	$	235,902	239,801	257,697	243,572	241,687
Loans, net of unearned income		460,901	476,908	453,651	430,946	426,410
Allowance for loan losses		4,386	4,790	4,757	4,643	4,289
Total assets		828,570	818,077	853,381	831,943	817,189
Total deposits		724,152	724,193	757,659	739,143	723,627
Long-term debt		—	—	3,217	3,217	7,217
Total stockholders' equity		98,328	89,055	86,906	82,177	79,949

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

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

(c) Regulatory capital ratios presented are for the Company's wholly-owned subsidiary, AuburnBank.

Table 3 - Average Balance and Net Interest Income Analysis

	Year ended December 31					
	2019			2018		
(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)	$ 474,259	$ 22,930	4.83%	$ 457,610	$ 21,766	4.76%
Securities - taxable	178,410	4,000	2.24%	181,485	4,051	2.23%
Securities - tax-exempt (2)	66,628	2,656	3.99%	71,065	2,921	4.11%
Total securities	245,038	6,656	2.72%	252,550	6,972	2.76%
Federal funds sold	20,223	423	2.09%	28,689	554	1.93%
Interest bearing bank deposits	36,869	795	2.16%	31,339	567	1.81%
Total interest-earning assets	776,389	30,804	3.97%	770,188	29,859	3.88%
Cash and due from banks	14,037			13,802		
Other assets	36,119			35,539		
Total assets	$ 826,545			$ 819,529		
Interest-bearing liabilities:						
Deposits:						
NOW	$ 134,430	710	0.53%	$ 125,533	428	0.34%
Savings and money market	218,630	969	0.44%	220,810	855	0.39%
Certificates of deposits	170,835	2,497	1.46%	184,010	2,329	1.27%
Total interest-bearing deposits	523,895	4,176	0.80%	530,353	3,612	0.68%
Short-term borrowings	1,443	7	0.49%	2,634	18	0.68%
Long-term debt	—	—	0.00%	1,022	46	4.50%
Total interest-bearing liabilities	525,338	4,183	0.80%	534,009	3,676	0.69%
Noninterest-bearing deposits	203,828			195,924		
Other liabilities	3,228			2,489		
Stockholders' equity	94,151			87,107		
Total liabilities and and stockholders' equity	$ 826,545			$ 819,529		
Net interest income and margin		$ 26,621	3.43%		$ 26,183	3.40%

(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%.

Table 4 - Volume and Rate Variance Analysis

(Dollars in thousands)	Years ended December 31, 2019 vs. 2018			Years ended December 31, 2018 vs. 2017		
	Net Change	Due to change in Rate (2)	Due to change in Volume (2)	Net Change	Due to change in Rate (2)	Due to change in Volume (2)
Interest income:						
Loans and loans held for sale	$ 1,164	358	806	$ 985	247	738
Securities - taxable	(51)	18	(69)	(178)	171	(349)
Securities - tax-exempt (1)	(265)	(88)	(177)	(624)	(673)	49
Total securities	(316)	(70)	(246)	(802)	(502)	(300)
Federal funds sold	(131)	46	(177)	213	284	(71)
Interest bearing bank deposits	228	109	119	138	319	(181)
Total interest income	$ 945	443	502	$ 534	348	186
Interest expense:						
Deposits:						
NOW	$ 282	235	47	$ 180	181	(1)
Savings and money market	114	124	(10)	3	39	(36)
Certificates of deposits	168	361	(193)	(22)	161	(183)
Total interest-bearing deposits	564	720	(156)	161	381	(220)
Short-term borrowings	(11)	(5)	(6)	—	6	(6)
Long-term debt	(46)	—	(46)	(79)	20	(99)
Total interest expense	507	715	(208)	82	407	(325)
Net interest income	$ 438	(272)	710	$ 452	(59)	511

(1) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 21% for 2019 and 2018 and 34% for 2017.

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

Table 5 - Loan Portfolio Composition

					December 31
(In thousands)	**2019**	**2018**	**2017**	**2016**	**2015**
Commercial and industrial	$ 56,782	63,467	59,086	49,850	52,479
Construction and land development	32,841	40,222	39,607	41,650	43,694
Commercial real estate	270,318	261,896	239,033	220,439	203,853
Residential real estate	92,575	102,597	106,863	110,855	116,673
Consumer installment	8,866	9,295	9,588	8,712	10,220
Total loans	461,382	477,477	454,177	431,506	426,919
Less: unearned income	(481)	(569)	(526)	(560)	(509)
Loans, net of unearned income	460,901	476,908	453,651	430,946	426,410
Less: allowance for loan losses	(4,386)	(4,790)	(4,757)	(4,643)	(4,289)
Loans, net	$ 456,515	472,118	448,894	426,303	422,121

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

	December 31, 2019						
(Dollars in thousands)	1 year or less	1 to 5 years	After 5 years	Total	Adjustable Rate	Fixed Rate	Total
Commercial and industrial	$ 18,555	12,398	25,829	56,782	10,552	46,230	56,782
Construction and land development	26,102	6,599	140	32,841	12,179	20,662	32,841
Commercial real estate	25,607	114,382	130,329	270,318	7,328	262,990	270,318
Residential real estate	8,013	27,337	57,225	92,575	41,652	50,923	92,575
Consumer installment	3,304	4,959	603	8,866	369	8,497	8,866
Total loans	$ 81,581	165,675	214,126	461,382	72,080	389,302	461,382

Table 7 - Allowance for Loan Losses and Nonperforming Assets

(Dollars in thousands)		Year ended December 31				
		2019	**2018**	**2017**	**2016**	**2015**
Allowance for loan losses:						
Balance at beginning of period	$	4,790	4,757	4,643	4,289	4,836
Charge-offs:						
Commercial and industrial		(364)	(52)	(449)	(97)	(100)
Commercial real estate		—	(38)	—	(194)	(866)
Residential real estate		(6)	(26)	(107)	(182)	(89)
Consumer installment		(38)	(52)	(40)	(67)	(59)
Total charge-offs		(408)	(168)	(596)	(540)	(1,114)
Recoveries:						
Commercial and industrial		117	70	461	29	22
Construction and land development		—	—	347	1,212	17
Commercial real estate		1	19	—	—	—
Residential real estate		109	79	115	127	313
Consumer installment		27	33	87	11	15
Total recoveries		254	201	1,010	1,379	367
Net (charge-offs) recoveries		(154)	33	414	839	(747)
Provision for loan losses		(250)	—	(300)	(485)	200
Ending balance	$	4,386	4,790	4,757	4,643	4,289
as a % of loans		0.95 %	1.00	1.05	1.08	1.01
as a % of nonperforming loans		2,345 %	2,691	160	196	158
Net charge-offs (recoveries) as % of average loans		0.03 %	(0.01)	(0.09)	(0.19)	0.18
Nonperforming assets:						
Nonaccrual/nonperforming loans	$	187	178	2,972	2,370	2,714
Other real estate owned		—	172	—	152	252
Total nonperforming assets	$	187	350	2,972	2,522	2,966
as a % of loans and other real estate owned		0.04 %	0.07	0.66	0.59	0.70
as a % total assets		0.02 %	0.04	0.35	0.30	0.36
Nonperforming loans as a % of total loans		0.04 %	0.04	0.66	0.55	0.64
Accruing loans 90 days or more past due	$	—	—	—	—	—

Table 8 - Allocation of Allowance for Loan Losses

	December 31									
	2019		2018		2017		2016		2015	
(Dollars in thousands)	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial and industrial	$ 577	12.3	$ 778	13.3	$ 653	13.0	$ 540	11.6	$ 523	12.3
Construction and land development	569	7.1	700	8.4	734	8.7	812	9.7	669	10.2
Commercial real estate	2,289	58.6	2,218	54.9	2,126	52.7	2,071	51.0	1,879	47.8
Residential real estate	813	20.1	946	21.5	1,071	23.5	1,107	25.7	1,059	27.3
Consumer installment	138	1.9	148	1.9	173	2.1	113	2.0	159	2.4
Total allowance for loan losses	$ 4,386		$ 4,790		$ 4,757		$ 4,643		$ 4,289	

* 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, 2019
Maturity of:	
3 months or less	$ 13,910
Over 3 months through 6 months	7,318
Over 6 months through 12 months	39,867
Over 12 months	46,588
Total CDs and other time deposits of $100,000 or more	$ 107,683

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, 2019. 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, 2019 based on the specified criteria.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2019 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, 2019, 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, 2019, 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, 2019 and 2018 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 6, 2020 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 6, 2020

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, 2019 and 2018, 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, 2019 and 2018, 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, 2019, 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 6, 2020 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 6, 2020

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES
Consolidated Balance Sheets

	December 31	
(Dollars in thousands, except share data)	**2019**	**2018**
Assets:		
Cash and due from banks	$ 15,172	$ 13,043
Federal funds sold	25,944	26,918
Interest bearing bank deposits	51,327	25,115
Cash and cash equivalents	92,443	65,076
Securities available-for-sale	235,902	239,801
Loans held for sale	2,202	383
Loans, net of unearned income	460,901	476,908
Allowance for loan losses	(4,386)	(4,790)
Loans, net	456,515	472,118
Premises and equipment, net	14,743	13,596
Bank-owned life insurance	19,202	18,765
Other assets	6,872	8,338
Total assets	$ 827,879	$ 818,077
Liabilities:		
Deposits:		
Noninterest-bearing	$ 196,218	$ 201,648
Interest-bearing	527,934	522,545
Total deposits	724,152	724,193
Federal funds purchased and securities sold under agreements to repurchase	1,069	2,300
Accrued expenses and other liabilities	4,330	2,529
Total liabilities	729,551	729,022
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	3,784	3,779
Retained earnings	101,801	95,635
Accumulated other comprehensive income (loss), net	2,059	(3,763)
Less treasury stock, at cost - 390,989 shares and 313,267 shares at December 31, 2019 and 2018, respectively	(9,355)	(6,635)
Total stockholders’ equity	98,328	89,055
Total liabilities and stockholders’ equity	$ 827,879	$ 818,077

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 2019	2018
Interest income:		
Loans, including fees	$ 22,930	$ 21,766
Securities:		
Taxable	4,000	4,051
Tax-exempt	2,099	2,308
Federal funds sold and interest bearing bank deposits	1,218	1,121
Total interest income	30,247	29,246
Interest expense:		
Deposits	4,176	3,612
Short-term borrowings	7	18
Long-term debt	—	46
Total interest expense	4,183	3,676
Net interest income	26,064	25,570
Provision for loan losses	(250)	—
Net interest income after provision for loan losses	26,314	25,570
Noninterest income:		
Service charges on deposit accounts	717	749
Mortgage lending	866	655
Bank-owned life insurance	437	435
Gain from loan guarantee program	1,717	—
Other	1,880	1,486
Securities losses, net	(123)	—
Total noninterest income	5,494	3,325
Noninterest expense:		
Salaries and benefits	11,931	10,653
Net occupancy and equipment	1,907	1,465
Professional fees	1,014	902
FDIC and other regulatory assessments	181	310
Other	4,664	4,544
Total noninterest expense	19,697	17,874
Earnings before income taxes	12,111	11,021
Income tax expense	2,370	2,187
Net earnings	$ 9,741	$ 8,834
Net earnings per share:		
Basic and diluted	$ 2.72	$ 2.42
Weighted average shares outstanding:		
Basic and diluted	3,581,476	3,643,780

See accompanying notes to consolidated financial statements

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

	Year ended December 31			
(Dollars in thousands)		**2019**		**2018**
Net earnings	$	9,741	$	8,834
Other comprehensive income (loss), net of tax:				
Unrealized net holding gain (loss) on securities		5,730		(3,197)
Reclassification adjustment for net loss on securities recognized in net earnings		92		—
Other comprehensive income (loss)		5,822		(3,197)
Comprehensive income	$	15,563	$	5,637

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 Shares Outstanding	Common Stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
Balance, December 31, 2017	3,643,668	$ 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	—	8	—	—	2	10
Balance, December 31, 2018	3,643,868	$ 39	$ 3,779	$ 95,635	$ (3,763)	$ (6,635)	$ 89,055
Net earnings	—	—	—	9,741	—	—	9,741
Other comprehensive income	—	—	—	—	5,822	—	5,822
Cash dividends paid ($1.00 per share)	—	—	—	(3,575)	—	—	(3,575)
Stock repurchases	(77,907)	—	—	—	—	(2,721)	(2,721)
Sale of treasury stock	185	—	5	—	—	1	6
Balance, December 31, 2019	3,566,146	$ 39	$ 3,784	$ 101,801	$ 2,059	$ (9,355)	$ 98,328

See accompanying notes to consolidated financial statements

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

	Year ended December 31	
(In thousands)	2019	2018
Cash flows from operating activities:		
Net earnings	$ 9,741	$ 8,834
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	(250)	—
Depreciation and amortization	1,157	938
Premium amortization and discount accretion, net	1,853	2,025
Deferred tax (benefit) expense	(153)	71
Net loss on securities available for sale	123	—
Net gain on sale of loans held for sale	(545)	(311)
Net gain on other real estate owned	(59)	—
Loans originated for sale	(30,407)	(27,681)
Proceeds from sale of loans	28,892	29,323
Increase in cash surrender value of bank owned life insurance	(437)	(435)
Net increase in other assets	(872)	(221)
Net increase (decrease) in accrued expenses and other liabilities	1,807	(402)
Net cash provided by operating activities	$ 10,850	$ 12,141
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	36,462	8,770
Proceeds from maturities of securities available-for-sale	55,078	22,673
Purchase of securities available-for-sale	(81,843)	(19,841)
Decrease (increase) in loans, net	15,771	(24,749)
Net purchases of premises and equipment	(1,809)	(240)
Decrease (increase) in FHLB stock	32	(20)
Proceeds from sale of other real estate owned	394	1,353
Net cash provided by (used in) investing activities	$ 24,085	$ (12,054)
Cash flows from financing activities:		
Net (decrease) increase in noninterest-bearing deposits	(5,430)	7,731
Net increase (decrease) in interest-bearing deposits	5,389	(41,197)
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(1,231)	(358)
Repayments or retirement of long-term debt	—	(3,217)
Stock repurchases	(2,721)	—
Dividends paid	(3,575)	(3,498)
Net cash used in financing activities	$ (7,568)	$ (40,539)
Net change in cash and cash equivalents	$ 27,367	$ (40,452)
Cash and cash equivalents at beginning of period	65,076	105,528
Cash and cash equivalents at end of period	$ 92,443	$ 65,076
Supplemental disclosures of cash flow information:		
Cash paid (received) during the period for:		
Interest	$ 4,092	$ 3,616
Income taxes	2,295	2,688
Gain from loan guarantee program	(1,717)	—
Supplemental disclosure of non-cash transactions:		
Initial recognition of operating lease right of use assets	$ 891	$ n/a
Initial recognition of operating lease liabilities	889	n/a
Real estate acquired through foreclosure	82	1,525

See accompanying notes to consolidated financial statements

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

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

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

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Auburn National Bancorporation Capital Trust I 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.

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. 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 ASC 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 ASC 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 – A gain on sale should be recognized when a contract for sale exists and control of the asset has been transferred to the buyer. ASC 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. In addition to the loan-to-value, the analysis is based on various other factors, including the credit quality of the borrower, the structure of the loan, and any other factors that may affect collectability.

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.

Change in Accounting Estimate

During the fourth quarter of 2019, the Company reassessed its estimate of the useful lives of certain fixed assets. The Company revised its original useful life estimate for certain land improvements, buildings and improvements and furniture, fixtures and equipment, with a carrying value of $0.5 million at December 31, 2019, to correspond with estimated demolition dates planned as part of the redevelopment project for our main campus. This is considered a change in accounting estimate, per ASC 250-10, where adjustments should be made prospectively. The effects of this change in accounting estimate on the 2019 consolidated financial statements was a decrease in net earnings of $0.2 million, or $0.04 per share.

Reclassifications

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

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, 2019. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

Accounting Standards Adopted in 2019

In 2019, the Company adopted new guidance related to the following Accounting Standards Update ("Update" or "ASU"):

- ASU 2016-02, *Leases; and*
- ASU 2017-02, *Targeted Improvements to Accounting for Hedging Activities.*

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 Company adopted ASU No. 2016-02 on January 1, 2019. ASU No. 2016-02 did not have a material impact on the Company's consolidated financial statements due to the fact the Company does not have any material leases.

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. The Company adopted ASU No. 2017-12 on January 1, 2019. ASU No. 2017-12 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, 2019, 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 estimated life of the security using the effective interest method. 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 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. Land improvements, buildings and improvements, and furniture, fixtures, 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.

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.

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 15, Fair Value.

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, 2019 and 2018, 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.

(Dollars in thousands, except share and per share data)	Year ended December 31 2019	2018
Basic and diluted:		
Net earnings	$ 9,741	$ 8,834
Weighted average common shares outstanding	3,581,476	3,643,780
Net earnings per share	$ 2.72	$ 2.42

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, 2019 and 2018, the Bank did not have a required reserve balance at the Federal Reserve Bank.

NOTE 4: SECURITIES

At December 31, 2019 and 2018, 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, 2019 and 2018, 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, 2019								
Agency obligations (a)	$ 4,993	27,245	18,470	—	50,708	215	98	$ 50,591
Agency RMBS (a)	—	560	4,510	118,207	123,277	798	261	122,740
State and political subdivisions	—	1,355	6,166	54,396	61,917	2,104	9	59,822
Total available-for-sale	$ 4,993	29,160	29,146	172,603	235,902	3,117	368	$ 233,153
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

(a) Includes securities issued by U.S. government agencies or government sponsored entities. Expected maturities of these securities may differ from contractual maturities because issues may have the right to call or repay obligations with or without prepayment penalties.

Securities with aggregate fair values of $147.8 million and $133.1 million at December 31, 2019 and 2018, 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, 2019 and 2018, 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, 2019 and 2018, 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, 2019:						
Agency obligations	$ 24,734	97	4,993	1	29,727	$ 98
Agency RMBS	40,126	98	21,477	163	61,603	261
State and political subdivisions	2,741	9	—	—	2,741	9
Total	$ 67,601	204	26,470	164	94,071	$ 368
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

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, 2019 and 2018, 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, 2019 and 2018, respectively.

Realized Gains and Losses

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

	Year ended December 31	
(Dollars in thousands)	**2019**	**2018**
Gross realized gains	$ 120	—
Gross realized losses	(243)	—
Realized losses, net	$ (123)	—

NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES

	December 31	
(In thousands)	**2019**	**2018**
Commercial and industrial	$ 56,782	$ 63,467
Construction and land development	32,841	40,222
Commercial real estate:		
Owner occupied	60,893	56,413
Multifamily	44,839	40,455
Other	164,586	165,028
Total commercial real estate	270,318	261,896
Residential real estate:		
Consumer mortgage	48,923	56,223
Investment property	43,652	46,374
Total residential real estate	92,575	102,597
Consumer installment	8,866	9,295
Total loans	461,382	477,477
Less: unearned income	(481)	(569)
Loans, net of unearned income	$ 460,901	$ 476,908

Loans secured by real estate were approximately 85.8% of the total loan portfolio at December 31, 2019. At December 31, 2019, 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, 2019 and 2018.

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
December 31, 2019:						
Commercial and industrial	$ 56,758	24	—	56,782	—	$ 56,782
Construction and land development	32,385	456	—	32,841	—	32,841
Commercial real estate:						
Owner occupied	60,893	—	—	60,893	—	60,893
Multifamily	44,839	—	—	44,839	—	44,839
Other	164,586	—	—	164,586	—	164,586
Total commercial real estate	270,318	—	—	270,318	—	270,318
Residential real estate:						
Consumer mortgage	47,151	1,585	—	48,736	187	48,923
Investment property	43,629	23	—	43,652	—	43,652
Total residential real estate	90,780	1,608	—	92,388	187	92,575
Consumer installment	8,802	64	—	8,866	—	8,866
Total	$ 459,043	2,152	—	461,195	187	$ 461,382
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

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 $9 thousand and $12 thousand for the years ended December 31, 2019 and 2018, respectively.

Allowance for Loan Losses

The allowance for loan losses as of and for the years ended December 31, 2019 and 2018, is presented below.

	Year ended December 31	
(In thousands)	2019	2018
Beginning balance	$ 4,790	$ 4,757
Charged-off loans	(408)	(168)
Recovery of previously charged-off loans	254	201
Net (charge-offs) recoveries	(154)	33
Provision for loan losses	(250)	—
Ending balance	$ 4,386	$ 4,790

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, 2019 and 2018, 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, 2019, the Company increased its look-back period to 43 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, 2019 and 2018.

(in thousands)		Commercial and industrial	Construction and land Development	Commercial Real Estate	Residential Real Estate	Consumer Installment		Total
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 (charge-offs)		18	—	(19)	53	(19)		33
Provision		107	(34)	111	(178)	(6)		—
Balance, December 31, 2018	$	778	700	2,218	946	148	$	4,790
Charge-offs		(364)	—	—	(6)	(38)		(408)
Recoveries		117	—	1	109	27		254
Net (charge-offs) recoveries		(247)	—	1	103	(11)		(154)
Provision		46	(131)	70	(236)	1		(250)
Balance, December 31, 2019	$	577	569	2,289	813	138	$	4,386

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, 2019 and 2018.

		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, 2019:							
Commercial and industrial	$	577	56,683	—	99	577	56,782
Construction and land development		569	32,841	—	—	569	32,841
Commercial real estate		2,289	270,318	—	—	2,289	270,318
Residential real estate		813	92,575	—	—	813	92,575
Consumer installment		138	8,866	—	—	138	8,866
Total	$	4,386	461,283	—	99	4,386	461,382
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

(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, 2019					
Commercial and industrial	$ 54,340	2,176	266	—	$ 56,782
Construction and land development	31,798	—	1,043	—	32,841
Commercial real estate:					
Owner occupied	59,898	917	78	—	60,893
Multifamily	44,839	—	—	—	44,839
Other	163,716	849	21	—	164,586
Total commercial real estate	268,453	1,766	99	—	270,318
Residential real estate:					
Consumer mortgage	45,247	962	2,527	187	48,923
Investment property	42,331	949	372	—	43,652
Total residential real estate	87,578	1,911	2,899	187	92,575
Consumer installment	8,742	60	64	—	8,866
Total	$ 450,911	5,913	4,371	187	$ 461,382
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

During the fourth quarter of 2019, the Company recognized a gain of $1.7 million resulting from the termination of a Loan Guarantee Program (the "Program") operated by the State of Alabama. The payment of $1.7 million received by the Company in October 2019 was recorded as a gain and included in noninterest income on the accompanying consolidated statements of earnings. The Program required a 1% fee on the commitment balance at origination and in return the Company received a guarantee of up to 50% of losses in the event of the borrower's default. As of December 31, 2019, the Company had 5 loans outstanding totaling $10.2 million that were enrolled in the Program prior to its termination by the State of Alabama. Despite being enrolled in the Program, these loans would have met the Company's normal loan underwriting criteria at origination. At December 31, 2019, all of these loans were categorized as Pass within the Company's credit quality asset classification.

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, 2019 and 2018.

	December 31, 2019			
(In thousands)	**Unpaid principal balance (1)**	**Charge-offs and payments applied (2)**	**Recorded investment (3)**	**Related allowance**
With no allowance recorded:				
Commercial and industrial	$ 335	(236)	$ 99	—
Total impaired loans	$ 335	(236)	$ 99	$ —

(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, 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.

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, 2019			Year ended December 31, 2018		
		Average recorded investment	Total interest income recognized		Average recorded investment	Total interest income recognized
Impaired loans:						
Commercial and industrial	$	8	—	$	9	—
Commercial real estate:						
Owner occupied		24	9		166	9
Other		—	—		1,145	—
Total commercial real estate		24	9		1,311	9
Total	$	32	9	$	1,320	9

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.

At December 31, 2019 the Company had no TDRs. The following is a summary of accruing and nonaccrual TDRs and the related loan losses, by portfolio segment and class at December 31, 2018.

(In thousands)	TDRs					
		Accruing	Nonaccrual	Total		Related Allowance
December 31, 2018						
Commercial real estate:						
Owner occupied	$	157	—	157	$	—
Total commercial real estate		157	—	157		—
Total	$	157	—	157	$	—

At December 31, 2019, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

There were no loans modified in a TDR during the year ended December 31, 2019. The following table summarizes loans modified in a TDR during the year ended December 31, 2018 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

Two loans were modified in a TDR during the year ended December 31, 2018. The only concessions granted by the Company were related to either a delay in the required payment of principal and/or interest or the interest rate at renewal was considered to be less than a market rate.

During the year ended December 31, 2019, the Company had no loans modified in a TDR within the previous 12 months for which there was a payment default. 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.

($ 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, 2019 and 2018 is presented below.

		December 31	
(Dollars in thousands)		2019	2018
Land and improvements	$	9,874	8,444
Buildings and improvements		10,094	9,871
Furniture, fixtures, and equipment		3,109	2,953
Total premises and equipment		23,077	21,268
Less: accumulated depreciation		(8,334)	(7,672)
Premises and equipment, net	$	14,743	13,596

Depreciation expense was approximately $662 thousand and $435 thousand for the years ended December 31, 2019 and 2018, 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, 2019 and 2018.

		Year ended December 31	
(Dollars in thousands)		2019	2018
Beginning balance	$	1,441	1,644
Additions, net		241 .	208
Amortization expense		(383)	(411)
Ending balance	$	1,299	1,441
Valuation allowance included in MSRs, net:			
Beginning of period	$	—	—
End of period		—	—
Fair value of amortized MSRs:			
Beginning of period	$	2,697	2,528
End of period		2,111	2,697

Data and assumptions used in the fair value calculation related to MSRs at December 31, 2019 and 2018, respectively, are presented below.

		December 31	
(Dollars in thousands)		2019	2018
Unpaid principal balance	$	274,227	289,981
Weighted average prepayment speed (CPR)		11.6 %	8.3
Discount rate (annual percentage)		10.0 %	10.0
Weighted average coupon interest rate		3.9 %	3.9
Weighted average remaining maturity (months)		255	250
Weighted average servicing fee (basis points)		25.0	25.0

At December 31, 2019, the weighted average amortization period for MSRs was 5.5 years. Estimated amortization expense for each of the next five years is presented below.

(Dollars in thousands)		December 31, 2019
2020	$	220
2021		182
2022		151
2023		126
2024		105

NOTE 8: DEPOSITS

At December 31, 2019, the scheduled maturities of certificates of deposit and other time deposits are presented below.

(Dollars in thousands)	December 31, 2019
2020	$ 92,740
2021	25,432
2022	36,643
2023	5,812
2024	6,572
Total certificates of deposit and other time deposits	$ 167,199

Additionally, at December 31, 2019 and 2018, approximately $57.4 million and $59.4 million, respectively, of certificates of deposit and other time deposits were issued in denominations greater than $250 thousand.

At December 31, 2019 and 2018, 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, 2019 and 2018, the composition of short-term borrowings is presented below.

	2019		2018	
(Dollars in thousands)	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
Federal funds purchased:				
As of December 31	$ —	—	$ —	—
Average during the year	1	2.58 %	2	2.50 %
Maximum outstanding at any month-end	—		—	
Securities sold under agreements to repurchase:				
As of December 31	$ 1,069	0.50 %	$ 2,300	0.50 %
Average during the year	1,442	0.50 %	2,632	0.50 %
Maximum outstanding at any month-end	2,261		3,241	

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, 2019.

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 $2.6 million and $5.6 million at December 31, 2019 and 2018, respectively, were pledged to secure securities sold under agreements to repurchase.

NOTE 10: LEASE COMMITMENTS

We lease certain office facilities and office equipment under operating leases. Rent expense for all operating leases totaled $0.2 million for both the years ended December 31, 2019 and 2018. On January 1, 2019, we adopted a new accounting standard which required the recognition of certain operating leases on our balance sheet as lease right of use assets (reported as component of other assets) and related lease liabilities (reported as a component of accrued expenses and other liabilities). At December 31, 2019, aggregate lease right of use assets and lease liabilities amounted to $785 thousand and $788 thousand, respectively. Rent expense includes amounts related to items that are not included in the determination of lease right of use assets including expenses related to short-term leases totaling $0.1 million for the year ended December 31, 2019.

Lease payments under operating leases that were applied to our operating lease liability totaled $129 thousand during the year ended December 31, 2019. The following table reconciles future undiscounted lease payments due under non-cancelable operating leases (those amounts subject to recognition) to the aggregate operating lease liability as of December 31, 2019:

(Dollars in thousands)		Remaining lease payments
2020	$	106
2021		93
2022		93
2023		93
2024		93
Thereafter		416
Total undiscounted operating lease liabilities	$	894
Imputed interest		106
Total operating lease liabilities included in the accompanying balance sheet	$	788
Weighted-average lease terms in years		8.89
Weighted-average discount rate		3.40 %

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 income (loss). Other comprehensive income (loss) for the years ended December 31, 2019 and 2018, is presented below.

(Dollars in thousands)		**Pre-tax amount**	**Tax benefit (expense)**	**Net of tax amount**
2019:				
Unrealized net holding gain on securities	$	7,651	(1,921)	5,730
Reclassification adjustment for net loss on securities recognized in net earnings		123	(31)	92
Other comprehensive income	$	7,774	(1,952)	5,822
2018:				
Unrealized net holding loss on securities	$	(4,269)	1,072	(3,197)
Other comprehensive loss	$	(4,269)	1,072	(3,197)

NOTE 12: INCOME TAXES

For the years ended December 31, 2019 and 2018 the components of income tax expense from continuing operations are presented below.

		Year ended December 31	
(Dollars in thousands)		**2019**	**2018**
Current income tax expense:			
Federal	$	1,939	1,685
State		584	431
Total current income tax expense		2,523	2,116
Deferred income tax (benefit) expense:			
Federal		(136)	56
State		(17)	15
Total deferred income tax (benefit) expense		(153)	71
Total income tax expense	$	2,370	2,187

Total income tax expense differs from the amounts computed by applying the statutory federal income tax rate of 21% to earnings before income taxes. A reconciliation of the differences for the years ended December 31, 2019 and 2018, is presented below.

	2019		2018	
(Dollars in thousands)	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings
Earnings before income taxes	$ 12,111		11,021	
Income taxes at statutory rate	2,543	21.0 %	2,315	21.0 %
Tax-exempt interest	(508)	(4.1)	(515)	(4.7)
State income taxes, net of federal tax effect	440	3.6	361	3.3
Bank-owned life insurance	(92)	(0.8)	(92)	(0.8)
Other	(13)	(0.1)	118	1.0
Total income tax expense	$ 2,370	19.6 %	2,187	19.8 %

The Company had a net deferred tax liability of $9 thousand included in other liabilities and a net deferred tax asset of $1.8 million included in other assets on the consolidated balance sheets at December 31, 2019 and 2018, respectively. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2019 and 2018 are presented below:

	December 31	
(Dollars in thousands)	2019	2018
Deferred tax assets:		
Allowance for loan losses	$ 1,102	1,203
Unrealized loss on securities	—	1,262
Accrued bonus	296	8
Right of use liability	198	—
Other	88	127
Total deferred tax assets	1,684	2,600
Deferred tax liabilities:		
Premises and equipment	315	280
Unrealized gain on securities	690	—
Originated mortgage servicing rights	326	362
Right of use asset	197	—
Other	165	168
Total deferred tax liabilities	1,693	810
Net deferred tax (liability) asset	$ (9)	1,790

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, 2019. 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, 2019 and 2018, is presented below.

(Dollars in thousands)		Year ended December 31 2019	2018
Net deferred tax (liability) asset:			
Balance, beginning of year	$	1,790	789
Deferred tax benefit (expense) related to continuing operations		153	(71)
Stockholders' equity, for accumulated other comprehensive (income) loss		(1,952)	1,072
Balance, end of year	$	(9)	1,790

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, 2019, 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 2020 relative to any tax positions taken prior to December 31, 2019. As of December 31, 2019, 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, 2016 through 2019.

NOTE 13: EMPLOYEE BENEFIT PLAN

The Company sponsors a qualified defined contribution retirement plan, the Auburn National Bancorporation, Inc. 401(k) Plan (the "Plan"). Effective January 1, 2019, the Plan was amended and restated. As part of this amendment and restatement, eligible employees may contribute up to 100% of eligible compensation, subject to statutory limits upon completion of 2 months of service. Furthermore, the Company now allows employer Safe Harbor contributions. Participants are immediately vested in employer Safe Harbor contributions. Effective January 1, 2019, the Company's matching contributions on behalf of participants were equal to $1.00 for each $1.00 contributed by participants, up to 3% of the participants' eligible compensation, and $0.50 for every $1.00 contributed by participants, up to 5% of the participants' eligible compensation, for a maximum matching contribution of 4% of the participants' eligible compensation. Prior to January 1, 2019, the Company made matching contributions on behalf of participants equal to $0.50 for each $1.00 contributed by participants, up to 6% of the participant's eligible compensation, for a maximum matching contribution of 3% of the participants' eligible compensation. Company matching contributions to the Plan were $264 thousand and $131 thousand for the years ended December 31, 2019 and 2018, respectively, and are included in salaries and benefits expense.

NOTE 14: 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, 2019 and 2018, the following financial instruments were outstanding whose contract amount represents credit risk:

(Dollars in thousands)		December 31 2019		2018
Commitments to extend credit	$	60,564	$	61,889
Standby letters of credit		1,921		7,026

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 $39 thousand and $73 thousand at December 31, 2019 and 2018, respectively.

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 15: 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, 2019 and 2018, 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.

The following table presents the balances of the assets and liabilities measured at fair value on a recurring as of December 31, 2019 and 2018, 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, 2019:				
Securities available-for-sale:				
Agency obligations	$ 50,708	—	50,708	—
Agency RMBS	123,277	—	123,277	—
State and political subdivisions	61,917	—	61,917	—
Total securities available-for-sale	235,902	—	235,902	—
Total assets at fair value	$ 235,902	—	235,902	—
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	—

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, 2019 and 2018, 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, 2019:					
Loans held for sale	$	2,202	—	2,202	—
Loans, net[(1)]		99	—	—	99
Other assets [(2)]		1,299	—	—	1,299
Total assets at fair value	$	3,600	—	2,202	1,398
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

[(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 other real estate owned and MSRs, net, both of which are carried at lower of cost or estimated fair value.

At December 31, 2019 and 2018 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, 2019, 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
December 31, 2019:					
Nonrecurring:					
Impaired loans	$	99	Appraisal	Appraisal discounts (%)	10.0%
Mortgage servicing rights, net		1,299	Discounted cash flow	Prepayment speed or CPR (%)	11.6%
				Discount rate (%)	10.0%
December 31, 2018:					
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. The fair value of loans was measured using an exit 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.

					Fair Value Hierarchy					
(Dollars in thousands)		**Carrying amount**		**Estimated fair value**		**Level 1 inputs**		**Level 2 inputs**		**Level 3 Inputs**
December 31, 2019:										
Financial Assets:										
Loans, net (1)	$	456,515	$	453,705	$	—	$	—	$	453,705
Loans held for sale		2,202		2,251		—		2,251		—
Financial Liabilities:										
Time Deposits	$	167,199	$	168,316	$	—	$	168,316	$	—
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	$	—

(1) Represents loans, net of unearned income and the allowance for loan losses. The fair value of loans was measured using an exit price notion.

NOTE 16: 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, 2018	$	8,207
New loans/advances		1,559
Repayments		(6,617)
Loans outstanding at December 31, 2019	$	3,149

During 2019 and 2018, 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, 2019 and 2018 amounted to $19.1 million and $19.8 million, respectively.

NOTE 17: 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, 2019.

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, 2019, 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, 2019 and 2018 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, 2019:						
Tier 1 Leverage Capital	$ 92,778	11.23 %	$ 33,043	4.00 %	$ 41,303	5.00 %
Common Equity Tier 1 Capital	$ 92,778	17.28 %	$ 24,162	4.50 %	$ 34,901	6.50 %
Tier 1 Risk-Based Capital	$ 92,778	17.28 %	$ 32,216	6.00 %	$ 42,955	8.00 %
Total Risk-Based Capital	$ 97,291	18.12 %	$ 42,955	8.00 %	$ 53,693	10.00 %
At December 31, 2018:						
Tier 1 Leverage Capital	$ 91,719	11.33 %	$ 32,368	4.00 %	$ 40,461	5.00 %
Common Equity Tier 1 Capital	$ 91,719	16.49 %	$ 25,031	4.50 %	$ 36,156	6.50 %
Tier 1 Risk-Based Capital	$ 91,719	16.49 %	$ 33,375	6.00 %	$ 44,500	8.00 %
Total Risk-Based Capital	$ 96,661	17.38 %	$ 44,500	8.00 %	$ 55,625	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, 2019, 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 $86.8 million of the Company's investment in the Bank was restricted from transfer in the form of dividends.

NOTE 18: 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)	2019	2018
Assets:		
Cash and due from banks	$ 4,119	1,941
Investment in bank subsidiary	94,837	87,956
Other assets	625	626
Total assets	$ 99,581	90,523
Liabilities:		
Accrued expenses and other liabilities	$ 1,253	1,468
Total liabilities	1,253	1,468
Stockholders' equity	98,328	89,055
Total liabilities and stockholders' equity	$ 99,581	90,523

CONDENSED STATEMENTS OF EARNINGS

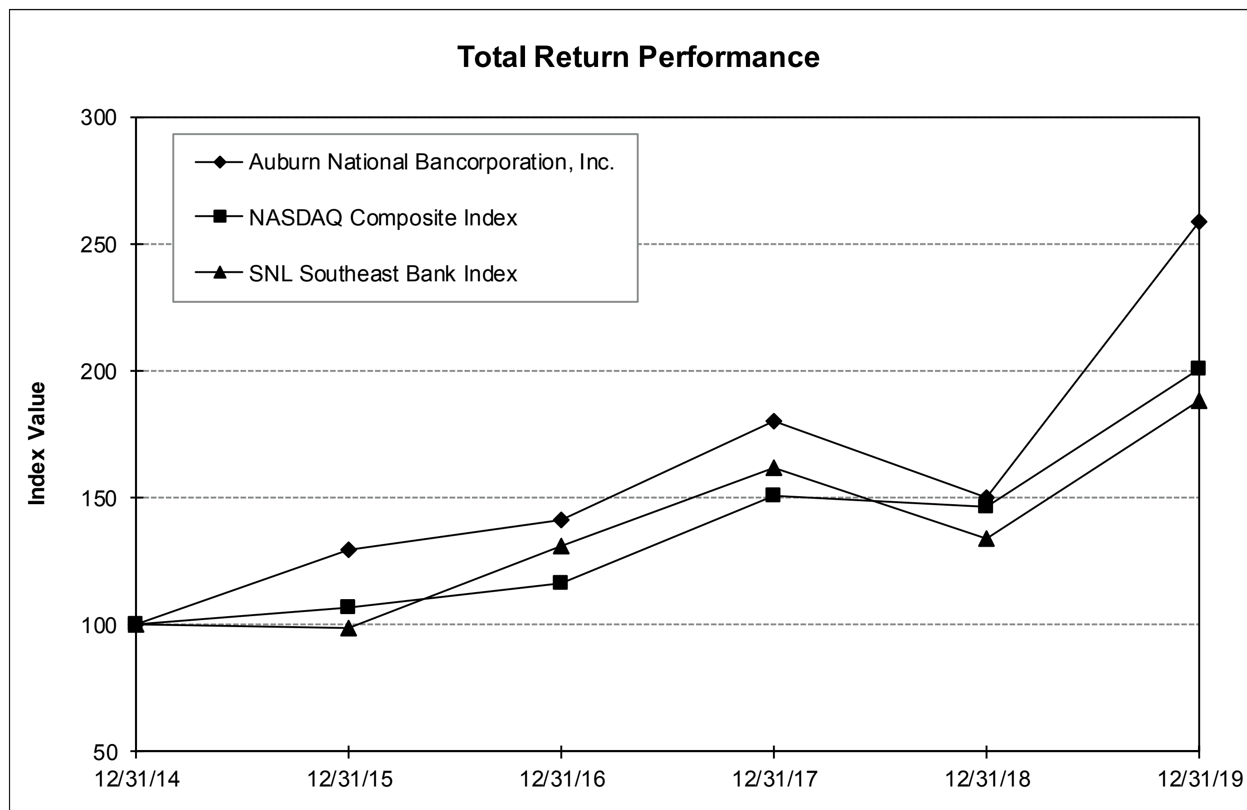
(Dollars in thousands)		Year ended December 31 2019	2018
Income:			
Dividends from bank subsidiary	$	8,574	6,533
Noninterest income		346	149
Total income		8,920	6,682
Expense:			
Interest expense		—	51
Noninterest expense		212	237
Total expense		212	288
Earnings before income tax expense (benefit) and equity in undistributed earnings of bank subsidiary		8,708	6,394
Income tax expense (benefit)		26	(28)
Earnings before equity in undistributed earnings of bank subsidiary		8,682	6,422
Equity in undistributed earnings of bank subsidiary		1,059	2,412
Net earnings	$	9,741	8,834

CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)		Year ended December 31 2019	2018
Cash flows from operating activities:			
Net earnings	$	9,741	8,834
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Net decrease in other assets		7	1,134
Net decrease in other liabilities		(215)	(70)
Equity in undistributed earnings of bank subsidiary		(1,059)	(2,412)
Net cash provided by operating activities		8,474	7,486
Cash flows from financing activities:			
Repayments or retirement of long-term debt		—	(3,217)
Dividends paid		(3,575)	(3,498)
Stock repurchases		(2,721)	—
Net cash used in financing activities		(6,296)	(6,715)
Net change in cash and cash equivalents		2,178	771
Cash and cash equivalents at beginning of period		1,941	1,170
Cash and cash equivalents at end of period	$	4,119	1,941

Stock Performance Graph

The following performance graph compares the cumulative, total return on the Company's Common Stock from December 31, 2014 to December 31, 2019, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a $100 investment on December 31, 2014). 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	**12/31/14**	**12/31/15**	**12/31/16**	**12/31/17**	**12/31/18**	**12/31/19**
Auburn National Bancorporation, Inc.	100.00	129.59	141.36	180.33	150.26	258.45
NASDAQ Composite Index	100.00	106.96	116.45	150.96	146.67	200.49
SNL Southeast Bank Index	100.00	98.44	130.68	161.65	133.56	188.08

Auburn National Bancorporation, Inc.

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Independent Auditors

Elliott Davis LLC
200 East Broad Street, Suite 500
Greenville, SC 29601

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 the Transfer Agent's home page at: www.computershare.com

Annual Meeting

Tuesday, May 12, 2020
3:00 p.m. (Central Time)

The Hotel at Auburn University
and Dixon Conference Center
241 S. College 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 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 headquarters.

Common Stock Listing

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

Dividend Reinvestment and Stock Purchase Plan

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

Direct Deposit of Dividends

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

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