

AUBURN NATIONAL BANCORPORATION, INC

Form 10-Q

July 29, 2016

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended June 30, 2016

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the transition period \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-26486

**Auburn National Bancorporation, Inc.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or other jurisdiction of

**63-0885779**  
(I.R.S. Employer

incorporation or organization)

Identification No.)

**100 N. Gay Street**

**Auburn, Alabama 36830**

**(334) 821-9200**

(Address and telephone number of principal executive offices)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes

No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting  
company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class  
Common Stock, \$0.01 par value per share

Outstanding at July 28, 2016  
3,643,503 shares

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## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

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**Table of Contents****PART 1. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Balance Sheets****(Unaudited)**

	<b>June 30,</b>	<b>December 31,</b>
	<b>2016</b>	<b>2015</b>
<i>(Dollars in thousands, except share data)</i>		
<b>Assets:</b>		
Cash and due from banks	\$ 11,872	\$ 9,806
Federal funds sold	48,571	57,395
Interest bearing bank deposits	103,977	46,729
Cash and cash equivalents	164,420	113,930
Securities available-for-sale	217,002	241,687
Loans held for sale	1,567	1,540
Loans, net of unearned income	430,694	426,410
Allowance for loan losses	(4,528)	(4,289)
Loans, net	426,166	422,121
Premises and equipment, net	11,710	11,866
Bank-owned life insurance	17,658	17,433
Other real estate owned	300	252
Other assets	7,233	8,360
Total assets	\$ 846,056	\$ 817,189
<b>Liabilities:</b>		
<b>Deposits:</b>		
Noninterest-bearing	\$ 167,741	\$ 156,817
Interest-bearing	579,798	566,810
Total deposits	747,539	723,627
Federal funds purchased and securities sold under agreements to repurchase	2,578	2,951
Long-term debt	7,217	7,217
Accrued expenses and other liabilities	3,914	3,445
Total liabilities	761,248	737,240

**Stockholders equity:**

Preferred stock of \$.01 par value; authorized 200,000 shares; no issued shares		
Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,767	3,766
Retained earnings	83,327	80,845
Accumulated other comprehensive income, net	4,313	1,937
Less treasury stock, at cost - 313,632 shares and 313,657 shares at June 30, 2016 and December 31, 2015, respectively	(6,638)	(6,638)
Total stockholders equity	84,808	79,949
Total liabilities and stockholders equity	\$ 846,056	\$ 817,189

*See accompanying notes to consolidated financial statements*

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## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

## Consolidated Statements of Earnings

(Unaudited)

<i>(In thousands, except share and per share data)</i>	Quarter ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
<b>Interest income:</b>				
Loans, including fees	\$ 5,172	\$ 5,217	\$ 10,268	\$ 10,223
Securities:				
Taxable	775	949	1,673	1,989
Tax-exempt	623	654	1,248	1,305
Federal funds sold and interest bearing bank deposits	156	51	282	90
Total interest income	6,726	6,871	13,471	13,607
<b>Interest expense:</b>				
Deposits	967	1,020	1,948	2,122
Short-term borrowings	3	4	7	10
Long-term debt	64	59	127	164
Total interest expense	1,034	1,083	2,082	2,296
<b>Net interest income</b>	5,692	5,788	11,389	11,311
<b>Provision for loan losses</b>			(600)	
<b>Net interest income after provision for loan losses</b>	5,692	5,788	11,989	11,311
<b>Noninterest income:</b>				
Service charges on deposit accounts	193	209	391	415
Mortgage lending	315	457	494	791
Bank-owned life insurance	113	112	225	513
Other	372	389	717	766
Securities gains, net				3
Total noninterest income	993	1,167	1,827	2,488
<b>Noninterest expense:</b>				
Salaries and benefits	2,446	2,291	4,851	4,559
Net occupancy and equipment	358	362	718	720
Professional fees	194	218	405	419

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FDIC and other regulatory assessments	122	118	244	243
Other real estate owned, net	(43)	1	(23)	18
Prepayment penalties on long-term debt				362
Other	944	1,039	1,935	2,022
<b>Total noninterest expense</b>	<b>4,021</b>	<b>4,029</b>	<b>8,130</b>	<b>8,343</b>
<b>Earnings before income taxes</b>	<b>2,664</b>	<b>2,926</b>	<b>5,686</b>	<b>5,456</b>
<b>Income tax expense</b>	<b>733</b>	<b>776</b>	<b>1,564</b>	<b>1,444</b>
<b>Net earnings</b>	<b>\$ 1,931</b>	<b>\$ 2,150</b>	<b>\$ 4,122</b>	<b>\$ 4,012</b>
<b>Net earnings per share:</b>				
Basic and diluted	\$ 0.53	\$ 0.59	\$ 1.13	\$ 1.10
<b>Weighted average shares outstanding:</b>				
Basic and diluted	3,643,503	3,643,413	3,643,493	3,643,389

*See accompanying notes to consolidated financial statements*



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## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

(Unaudited)

<i>(Dollars in thousands)</i>	<b>Quarter ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
<b>Net earnings</b>	\$ 1,931	\$ 2,150	\$ 4,122	\$ 4,012
<b>Other comprehensive income (loss), net of tax:</b>				
Unrealized net holding gain (loss) on securities	810	(1,842)	2,376	(1,156)
Reclassification adjustment for net gain on securities recognized in net earnings				(2)
<b>Other comprehensive income (loss)</b>	<b>810</b>	<b>(1,842)</b>	<b>2,376</b>	<b>(1,158)</b>
<b>Comprehensive income</b>	<b>\$ 2,741</b>	<b>\$ 308</b>	<b>\$ 6,498</b>	<b>\$ 2,854</b>

*See accompanying notes to consolidated financial statements*

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## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

## Consolidated Statements of Stockholders Equity

(Unaudited)

<i>(Dollars in thousands, except share data)</i>	Common Stock		Additional paid-in	Retained	Accumulated other comprehensive	Treasury	Total
	Shares	Amount	capital	earnings	income	stock	
<b>Balance, December 31, 2014</b>	3,957,135	\$ 39	\$ 3,763	\$ 76,193	\$ 2,443	\$ (6,639)	\$ 75,799
Net earnings				4,012			4,012
Other comprehensive loss					(1,158)		(1,158)
Cash dividends paid (\$0.44 per share)				(1,603)			(1,603)
Sale of treasury stock (100 shares)			2			1	3
<b>Balance, June 30, 2015</b>	3,957,135	\$ 39	\$ 3,765	\$ 78,602	\$ 1,285	\$ (6,638)	\$ 77,053
<b>Balance, December 31, 2015</b>	3,957,135	\$ 39	\$ 3,766	\$ 80,845	\$ 1,937	\$ (6,638)	\$ 79,949
Net earnings				4,122			4,122
Other comprehensive income					2,376		2,376
Cash dividends paid (\$0.45 per share)				(1,640)			(1,640)
Sale of treasury stock (25 shares)			1				1

<b>Balance, June 30, 2016</b>	3,957,135	\$	39	\$	3,767	\$	83,327	\$	4,313	\$	(6,638)	\$	84,808
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*See accompanying notes to consolidated financial statements*

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

<i>(In thousands)</i>	<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>
<b>Cash flows from operating activities:</b>		
Net earnings	\$ 4,122	\$ 4,012
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	(600)	
Depreciation and amortization	544	545
Premium amortization and discount accretion, net	692	804
Net gain on securities available-for-sale		(3)
Net gain on sale of loans held for sale	(367)	(644)
Increase (decrease) in MSR valuation allowance	1	(39)
Net (gain) loss on other real estate owned	(43)	5
Loss on prepayment of long-term debt		362
Loans originated for sale	(20,327)	(38,404)
Proceeds from sale of loans	20,523	36,883
Increase in cash surrender value of bank-owned life insurance	(225)	(237)
Income recognized from death benefit on bank-owned life insurance		(276)
Net (increase) decrease in other assets	(425)	237
Net increase (decrease) in accrued expenses and other liabilities	510	(84)
Net cash provided by operating activities	4,405	3,161
<b>Cash flows from investing activities:</b>		
Proceeds from maturities of securities available-for-sale	30,922	16,698
Purchase of securities available-for-sale	(3,164)	(4,637)
Increase in loans, net	(3,693)	(5,491)
Net purchases of premises and equipment	(57)	(415)
Proceeds from bank-owned life insurance death benefit		1,319
(Increase) decrease in FHLB stock	(25)	191
Proceeds from sale of other real estate owned	203	30
Net cash provided by investing activities	24,186	7,695
<b>Cash flows from financing activities:</b>		
Net increase in noninterest-bearing deposits	10,924	19,576
Net increase in interest-bearing deposits	12,988	3,028
	(373)	(1,769)

Net decrease in federal funds purchased and securities sold under agreements to repurchase		
Repayments or retirement of long-term debt		(5,362)
Dividends paid	(1,640)	(1,603)
Net cash provided by financing activities	21,899	13,870
Net change in cash and cash equivalents	50,490	24,726
Cash and cash equivalents at beginning of period	113,930	83,503
<b>Cash and cash equivalents at end of period</b>	<b>\$ 164,420</b>	<b>\$ 108,229</b>

**Supplemental disclosures of cash flow information:**

Cash paid during the period for:

Interest	\$ 2,062	\$ 2,366
Income taxes	1,403	1,241

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

Real estate acquired through foreclosure	248
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*See accompanying notes to consolidated financial statements*

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**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

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

**General**

Auburn National Bancorporation, Inc. (the Company) provides a full range of banking services to individual and corporate customers in Lee County, Alabama and surrounding counties through its wholly owned subsidiary, AuburnBank (the Bank). The Company does not have any segments other than banking that are considered material.

**Basis of Presentation and Use of Estimates**

The unaudited consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The unaudited consolidated financial statements include, in the opinion of management, all adjustments necessary to present a fair statement of the financial position and the results of operations for all periods presented. All such adjustments are of a normal recurring nature. The results of operations in the interim statements are not necessarily indicative of the results of operations that the Company and its subsidiaries may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses 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 other-than-temporary impairment on investment securities, the determination of the allowance for loan losses, fair value of financial instruments, and the valuation of deferred tax assets and other real estate owned.

**Subsequent Events**

The Company has evaluated the effects of events and transactions through the date of this filing that have occurred subsequent to June 30, 2016. The Company does not believe there were any material subsequent events during this period that would have required further recognition or disclosure in the unaudited consolidated financial statements included in this report.

**Accounting Developments**

In the first quarter of 2016, the Company adopted new guidance related to the following Accounting Standards Updates ( Updates or ASUs ):

ASU 2015-02, *Amendments to the Consolidation Analysis*;

ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*; and

ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*.  
Information about these pronouncements is described in more detail below.

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ASU 2015-02, *Amendments to the Consolidation Analysis*, affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. Specifically, the amendments: (1) Modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities ( VIEs ) or voting interest entities; (2) Eliminate the presumption that a general partner should consolidate a limited partnership; (3) Affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships; and (4) Provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. Adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, requires that debt issuance costs related to a recognized debt liability be presented on the balance sheet as a direct deduction from the debt liability, rather than as an asset. Adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*, provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The new guidance does not change the accounting for a customer's accounting for service contracts. Adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

**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 respective period. 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. At June 30, 2016 and 2015, respectively, the Company had no such securities or rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted earnings per share calculation.

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

<i>(In thousands, except share and per share data)</i>	<b>Quarter ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
<b>Basic and diluted:</b>				
Net earnings	\$ 1,931	\$ 2,150	\$ 4,122	\$ 4,012
Weighted average common shares outstanding	3,643,503	3,643,413	3,643,493	3,643,389
Net earnings per share	\$ 0.53	\$ 0.59	\$ 1.13	\$ 1.10

**NOTE 3: VARIABLE INTEREST ENTITIES**

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



At June 30, 2016, the Company did not have any consolidated VIEs to disclose but did have one nonconsolidated VIE, discussed below.

**Table of Contents****Trust Preferred Securities**

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

The following table summarizes VIEs that are not consolidated by the Company as of June 30, 2016.

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

**NOTE 4: SECURITIES**

At June 30, 2016 and December 31, 2015, respectively, all securities within the scope of Accounting Standards Codification ( 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 June 30, 2016 and December 31, 2015, respectively, are presented below.

<i>(Dollars in thousands)</i>	1 year	1 to 5	5 to 10	After 10	Fair	Gross Unrealized		Amortized
	or less	years	years	years	Value	Gains	Losses	Cost
<b>June 30, 2016</b>								
Agency obligations (a)	\$ 3,113	23,136	16,390		42,639	943		\$ 41,696
Agency RMBS (a)		1,265	20,223	81,391	102,879	2,132		100,747
State and political subdivisions		2,004	11,440	58,040	71,484	3,759		67,725
<b>Total available-for-sale</b>	<b>\$ 3,113</b>	<b>26,405</b>	<b>48,053</b>	<b>139,431</b>	<b>217,002</b>	<b>6,834</b>		<b>\$ 210,168</b>

**December 31,  
2015**

Agency obligations (a)	\$	5,000	25,852	19,463	9,770	60,085	384	518	\$	60,219
Agency RMBS (a)			1,623	13,511	95,820	110,954	968	780		110,766
State and political subdivisions			497	12,094	58,057	70,648	3,022	7		67,633
Total available-for-sale	\$	5,000	27,972	45,068	163,647	241,687	4,374	1,305	\$	238,618

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

Securities with aggregate fair values of \$155.2 million and \$133.3 million at June 30, 2016 and December 31, 2015, 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 are cost-method investments. The carrying amounts of cost-method investments were \$1.4 million at June 30, 2016 and December 31, 2015, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank ( FRB ) stock.

**Table of Contents****Gross Unrealized Losses and Fair Value**

The Company had no gross unrealized losses at June 30, 2016. The fair values and gross unrealized losses on securities at December 31, 2015 segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer, are presented below.

	Less than 12 Months		12 Months or Longer		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Losses	Value	Losses	Value	Losses
<i>(Dollars in thousands)</i>						
<b>December 31, 2015:</b>						
Agency obligations	\$ 8,157	2	24,444	516	\$ 32,601	518
Agency RMBS	42,345	367	18,184	413	60,529	780
State and political subdivisions	267	1	969	6	1,236	7
<b>Total</b>	<b>\$ 50,769</b>	<b>370</b>	<b>43,597</b>	<b>935</b>	<b>\$ 94,366</b>	<b>1,305</b>

***Cost-method investments***

At June 30, 2016, cost-method investments with an aggregate cost of \$1.4 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

The carrying values of the Company's investment securities could decline in the future if the financial condition of an issuer deteriorates and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that 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 June 30, 2016 and December 31, 2015, 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 six months ended June 30, 2016 and 2015, respectively.

**Realized Gains and Losses**

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

<i>(Dollars in thousands)</i>	<b>Quarter ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
Gross realized gains	\$		\$	3
Realized gains, net	\$		\$	3

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**Table of Contents****NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES**

	<b>June 30,</b>	<b>December 31,</b>
<i>(In thousands)</i>	<b>2016</b>	<b>2015</b>
Commercial and industrial	\$ 50,190	\$ 52,479
Construction and land development	49,346	43,694
Commercial real estate:		
Owner occupied	47,600	46,602
Multi-family	43,279	45,264
Other	117,946	111,987
<b>Total commercial real estate</b>	<b>208,825</b>	<b>203,853</b>
Residential real estate:		
Consumer mortgage	68,077	70,009
Investment property	45,686	46,664
<b>Total residential real estate</b>	<b>113,763</b>	<b>116,673</b>
Consumer installment	9,125	10,220
<b>Total loans</b>	<b>431,249</b>	<b>426,919</b>
Less: unearned income	(555)	(509)
<b>Loans, net of unearned income</b>	<b>\$ 430,694</b>	<b>\$ 426,410</b>

Loans secured by real estate were approximately 86.2% of the Company's total loan portfolio at June 30, 2016. At June 30, 2016, the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama, and surrounding areas.

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

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

*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 credit 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.

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*Commercial real estate ( CRE )* includes loans disaggregated into three classes: (1) owner occupied, (2) multifamily 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.

*Multi-family* 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 that are not owner occupied. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, and warehouses leased to local businesses. 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 of credit 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 and property value, 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.



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The following is a summary of current, accruing past due, and nonaccrual loans by portfolio segment and class as of June 30, 2016 and December 31, 2015.

	Accruing		Accruing		Total	
	Current	Past Due	30-89 Days	Greater than 90 days	Accruing Loans	Non-Accrual Loans
<b>June 30, 2016:</b>						
Commercial and industrial	\$ 50,125	25			50,150	40
Construction and land development	49,291				49,291	55
Commercial real estate:						
Owner occupied	47,600				47,600	
Multi-family	43,279				43,279	
Other	116,382				116,382	1,564
Total commercial real estate	207,261				207,261	1,564
Residential real estate:						
Consumer mortgage	67,510	557			68,067	10
Investment property	45,598	88			45,686	
Total residential real estate	113,108	645			113,753	10
Consumer installment	9,074	51			9,125	
Total	\$ 428,859	721			429,580	1,669
<b>December 31, 2015:</b>						
Commercial and industrial	\$ 52,387	49			52,436	43
Construction and land development	43,111				43,111	583
Commercial real estate:						
Owner occupied	46,372				46,372	230
Multi-family	45,264				45,264	
Other	110,467				110,467	1,520
Total commercial real estate	202,103				202,103	1,750
Residential real estate:						
Consumer mortgage	68,579	1,105			69,684	325

Investment property	46,435	229	46,664		46,664
Total residential real estate	115,014	1,334	116,348	325	116,673
Consumer installment	10,179	28	10,207	13	10,220
Total	\$ 422,794	1,411	424,205	2,714	\$ 426,919

### 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.

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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, the impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

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

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

As part of the Company's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment. 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 each loan segment. 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 Company calculates average losses for all loan segments using a rolling 20 quarter historical period. 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 June 30, 2016 and December 31, 2015, and for the periods 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.

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The following table details the changes in the allowance for loan losses by portfolio segment for the respective periods.

	<b>June 30, 2016</b>					
<i>(In thousands)</i>	<b>Commercial and industrial</b>	<b>Construction and land development</b>	<b>Commercial real estate</b>	<b>Residential real estate</b>	<b>Consumer installment</b>	<b>Total</b>
<b>Quarter ended:</b>						
Beginning balance	\$ 517	695	2,403	1,026	133	\$ 4,774
Charge-offs	(83)		(194)	(37)	(2)	(316)
Recoveries	3	5		58	4	70
Net (charge-offs) recoveries	(80)	5	(194)	21	2	(246)
Provision for loan losses	69	44	(117)	14	(10)	
Ending balance	\$ 506	744	2,092	1,061	125	\$ 4,528
<b>Six months ended:</b>						
Beginning balance	\$ 523	669	1,879	1,059	159	\$ 4,289
Charge-offs	(83)		(194)	(155)	(28)	(460)
Recoveries	23	1,203		65	8	1,299
Net (charge-offs) recoveries	(60)	1,203	(194)	(90)	(20)	839
Provision for loan losses	43	(1,128)	407	92	(14)	(600)
Ending balance	\$ 506	744	2,092	1,061	125	\$ 4,528

**June 30, 2015**

	<b>June 30, 2015</b>					
<i>(In thousands)</i>	<b>Commercial and industrial</b>	<b>Construction and land development</b>	<b>Commercial real estate</b>	<b>Residential real estate</b>	<b>Consumer installment</b>	<b>Total</b>
<b>Quarter ended:</b>						
Beginning balance	\$ 644	830	1,888	1,153	207	\$ 4,722
Charge-offs					(5)	(5)
Recoveries	3	4		151	11	169
Net recoveries (charge-offs)	3	4		151	6	164
Provision for loan losses	34	(194)	258	(124)	26	
Ending balance	\$ 681	640	2,146	1,180	239	\$ 4,886

**Six months ended:**

Beginning balance	\$ 639	974	1,928	1,119	176	\$	4,836
Charge-offs	(58)			(59)	(23)		(140)
Recoveries	4	9		165	12		190
Net (charge-offs) recoveries	(54)	9		106	(11)		50
Provision for loan losses	96	(343)	218	(45)	74		
Ending balance	\$ 681	640	2,146	1,180	239	\$	4,886

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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 June 30, 2016 and 2015.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
	Allowance	Recorded	Allowance	Recorded	Allowance	Recorded
	for	investment	for	investment	for	investment
	loan	in loans	loan	in loans	loan	in loans
(In thousands)	losses	in loans	losses	in loans	losses	in loans
<b>June 30, 2016:</b>						
Commercial and industrial	\$ 506	50,159		31	506	50,190
Construction and land development	744	49,291		55	744	49,346
Commercial real estate	1,995	206,258	97	2,567	2,092	208,825
Residential real estate	1,061	113,763			1,061	113,763
Consumer installment	125	9,125			125	9,125
<b>Total</b>	<b>\$ 4,431</b>	<b>428,596</b>	<b>97</b>	<b>2,653</b>	<b>4,528</b>	<b>431,249</b>
<b>June 30, 2015:</b>						
Commercial and industrial	\$ 681	57,246		64	681	57,310
Construction and land development	640	38,252		602	640	38,854
Commercial real estate	1,672	182,465	474	1,659	2,146	184,124
Residential real estate	1,180	115,039			1,180	115,039
Consumer installment	239	13,632			239	13,632
<b>Total</b>	<b>\$ 4,412</b>	<b>406,634</b>	<b>474</b>	<b>2,325</b>	<b>4,886</b>	<b>408,959</b>

(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 non-impaired 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 not expected.

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<i>(In thousands)</i>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>		<b>Total loans</b>
			<b>Accruing</b>	<b>Nonaccrual</b>	
<b>June 30, 2016:</b>					
Commercial and industrial	\$ 46,015	3,850	285	40	\$ 50,190
Construction and land development	48,873	53	365	55	49,346
Commercial real estate:					
Owner occupied	46,874	275	451		47,600
Multi-family	43,279				43,279
Other	115,568	354	460	1,564	117,946
Total commercial real estate	205,721	629	911	1,564	208,825
Residential real estate:					
Consumer mortgage	62,702	2,501	2,864	10	68,077
Investment property	44,588	107	991		45,686
Total residential real estate	107,290	2,608	3,855	10	113,763
Consumer installment	9,010	31	84		9,125
Total	\$ 416,909	7,171	5,500	1,669	\$ 431,249
<b>December 31, 2015:</b>					
Commercial and industrial	\$ 48,038	4,075	323	43	\$ 52,479
Construction and land development	42,458	60	593	583	43,694
Commercial real estate:					
Owner occupied	45,772	381	219	230	46,602
Multi-family	45,264				45,264
Other	110,159	36	272	1,520	111,987
Total commercial real estate	201,195	417	491	1,750	203,853
Residential real estate:					
Consumer mortgage	64,502	1,964	3,218	325	70,009
Investment property	45,399	112	1,153		46,664
Total residential real estate	109,901	2,076	4,371	325	116,673
Consumer installment	10,038	55	114	13	10,220
Total	\$ 411,630	6,683	5,892	2,714	\$ 426,919

**Impaired loans**

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



Individually evaluated impaired loans equal to or greater than \$500,000 secured by real estate (nonaccrual construction and land development, commercial real estate, and residential real estate loans).

Individually evaluated impaired loans equal to or greater than \$250,000 not secured by real estate (nonaccrual commercial and industrial and consumer installment loans).

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The following tables set forth certain information regarding the Company's impaired loans that were individually evaluated for impairment at June 30, 2016 and December 31, 2015.

**June 30, 2016**

<i>(In thousands)</i>	<b>Unpaid principal balance (1)</b>	<b>Charge-offs and payments applied (2)</b>	<b>Recorded investment (3)</b>	<b>Related allowance</b>
<b>With no allowance recorded:</b>				
Commercial and industrial	\$ 31		31	
Construction and land development	159	(104)	55	
Commercial real estate:				
Other	2,478	(914)	1,564	
Total commercial real estate	2,478	(914)	1,564	
<b>Total</b>	<b>\$ 2,668</b>	<b>(1,018)</b>	<b>1,650</b>	
<b>With allowance recorded:</b>				
Commercial real estate:				
Owner occupied	1,003		1,003	97
Total commercial real estate	1,003		1,003	97
<b>Total</b>	<b>\$ 1,003</b>		<b>1,003</b>	<b>\$ 97</b>
<b>Total impaired loans</b>	<b>\$ 3,671</b>	<b>(1,018)</b>	<b>2,653</b>	<b>\$ 97</b>

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

(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance subsequent to the loans being placed on nonaccrual status.

(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, 2015**

<i>(In thousands)</i>	<b>Unpaid principal balance (1)</b>	<b>Charge-offs and payments applied (2)</b>	<b>Recorded investment (3)</b>	<b>Related allowance</b>
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<b>With no allowance recorded:</b>				
Commercial and industrial	\$	48		48
Construction and land development		2,582	(1,999)	583
Commercial real estate:				
Owner occupied		308	(78)	230
Other		2,136	(617)	1,519
Total commercial real estate		2,444	(695)	1,749
Total	\$	5,074	(2,694)	2,380
<b>With allowance recorded:</b>				
Commercial real estate:				
Owner occupied		1,027		1,027
				121
Total commercial real estate		1,027		1,027
				121
Total	\$	1,027		1,027
				\$ 121
<b>Total impaired loans</b>	\$	6,101	(2,694)	3,407
				\$ 121

(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 subsequent to the loans being placed on nonaccrual status.

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

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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 during the respective periods.

	Quarter ended June 30, 2016		9 months ended June 30, 2016	
	Average	Total	Average	Total
	recorded	interest	recorded	interest
	investment	recognized	investment	recognized
<i>(In thousands)</i>				
<b>Impaired loans:</b>				
Commercial and industrial	\$ 36	1	40	2
Construction and land development	60		138	
Commercial real estate:				
Owner occupied	1,009	11	1,015	26
Other	1,699		1,718	
Total commercial real estate	2,708	11	2,733	26
Total	\$ 2,804	12	2,911	28

	Quarter ended June 30, 2015		9 months ended June 30, 2015	
	Average	Total	Average	Total
	recorded	interest	recorded	interest
	investment	recognized	investment	recognized
<i>(In thousands)</i>				
<b>Impaired loans:</b>				
Commercial and industrial	\$ 64	1	66	2
Construction and land development	608		613	
Commercial real estate:				
Owner occupied	1,202	9	1,143	21
Other	466	8	538	18
Total commercial real estate	1,668	17	1,681	39
Residential real estate:				

Consumer mortgages	512	158	648	173
Investment property	100	76	130	76
Total residential real estate	612	234	778	249
Total	\$ 2,952	252	3,138	290

Interest income recognized for the quarter and six months ended June 30, 2015 included non-routine interest recoveries of \$225 thousand related to two impaired residential real estate loans that paid off in June 2015. Excluding the interest recoveries on these two loans, interest income recognized on impaired loans for the quarter and six months ended June 30, 2015 would have been \$27 thousand and \$65 thousand, respectively.

### Troubled Debt Restructurings

Impaired loans also include troubled debt restructurings ( TDRs ). In the normal course of business, management may grant concessions to borrowers that 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 making the determination of whether a loan modification is a TDR, the Company considers the individual facts and circumstances surrounding each modification. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructure.

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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 individually evaluated for possible impairment.

The following is a summary of accruing and nonaccrual TDRs, which are included in the impaired loan totals, and the related allowance for loan losses, by portfolio segment and class as of June 30, 2016 and December 31, 2015.

<i>(In thousands)</i>	TDRs			Related Allowance
	Accruing	Nonaccrual	Total	
<b>June 30, 2016</b>				
Commercial and industrial	\$ 31		31	\$
Construction and land development		55	55	
Commercial real estate:				
Owner occupied	1,003		1,003	97
Other		1,564	1,564	
Total commercial real estate	1,003	1,564	2,567	97
Total	\$ 1,034	1,619	2,653	\$ 97
<b>December 31, 2015</b>				
Commercial and industrial	\$ 48		48	\$
Construction and land development		582	582	
Commercial real estate:				
Owner occupied	1,027	230	1,257	121
Total commercial real estate	1,027	230	1,257	121
Total	\$ 1,075	812	1,887	\$ 121

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

Quarter ended June 30,		Six months June 30,	
Pre-	Post -	Pre-	Post -

			modification	modification		modification	modification
			outstanding	outstanding	Number	outstanding	outstanding
	Number		recorded	recorded	of	recorded	recorded
	of		investment	investment	contracts	investment	investment
<i>(Dollars in thousands)</i>	contracts		investment	investment	contracts	investment	investment
<b>2016:</b>							
Commercial real estate:							
Other	1	\$	1,509	1,509	1	\$	1,509
Total commercial real estate	1		1,509	1,509	1		1,509
Total	1	\$	1,509	1,509	1	\$	1,509
<b>2015:</b>							
Commercial and industrial	1	\$	61	66	1	\$	61
Construction and land development					1		116
Commercial real estate:							
Other					1		592
Total commercial real estate					1		592
Total	1	\$	61	66	3	\$	769

The majority of the loans modified in a TDR during the quarter and six months ended June 30, 2016 and 2015, included permitting delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was considered to be less than a market rate.

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There were no TDRs with default payments during the quarter and six months ended June 30, 2016. The following table summarizes the recorded investment in loans modified in a TDR within the previous 12 months for which there was a payment default (defined as 90 days or more past due) during the respective periods.

<i>(Dollars in thousands)</i>	<b>Quarter ended June 30,</b>		<b>Six months Ended June 30,</b>	
	<b>Number of</b>	<b>Recorded</b>	<b>Number of</b>	<b>Recorded</b>
	<b>Contracts</b>	<b>investment<sup>(1)</sup></b>	<b>Contracts</b>	<b>investment<sup>(1)</sup></b>
<b>2015:</b>				
Commercial real estate:				
Owner occupied	\$	1	\$	261
Total commercial real estate		1		261
Residential real estate:				
Investment property		1		150
Total residential real estate		1		150
Total	\$	2	\$	411

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

**NOTE 6: MORTGAGE SERVICING RIGHTS, NET**

Mortgage servicing rights (MSRs) are recognized based on the fair value of the servicing rights on the date the corresponding mortgage loans are sold. An estimate of the fair value 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 rates, default rates, costs 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 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 respective periods.



<i>(Dollars in thousands)</i>	<b>Quarter ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
<b>MSRs, net:</b>				
Beginning balance	\$ 2,235	\$ 2,355	\$ 2,316	\$ 2,388
Additions, net	88	154	145	265
Amortization expense	(176)	(199)	(314)	(333)
(Increase) decrease in valuation allowance	(1)	49	(1)	39
Ending balance	\$ 2,146	\$ 2,359	\$ 2,146	\$ 2,359
<b>Valuation allowance included in MSRs, net:</b>				
Beginning of period	\$	\$ 63	\$	\$ 53
End of period	1	14	1	14
<b>Fair value of amortized MSRs:</b>				
Beginning of period	\$ 2,906	\$ 3,066	\$ 3,086	\$ 3,238
End of period	2,539	3,014	2,539	3,014

**Table of Contents****NOTE 7: DERIVATIVE INSTRUMENTS**

Financial derivatives are reported at fair value in other assets or other liabilities on the accompanying Consolidated Balance Sheets. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings within other noninterest income on the accompanying consolidated statements of earnings. From time to time, the Company may enter into interest rate swaps ( swaps ) to facilitate customer transactions and meet their financing needs. Upon entering into these swaps, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments.

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

A summary of the Company's interest rate swap agreements at June 30, 2016 and December 31, 2015 is presented below.

<i>(Dollars in thousands)</i>	<b>Notional</b>	<b>Other Assets Estimated Fair Value</b>	<b>Other Liabilities Estimated Fair Value</b>
<b>June 30, 2016:</b>			
Pay fixed / receive variable	\$ 4,142		375
Pay variable / receive fixed	4,142	375	
Total interest rate swap agreements	\$ 8,284	375	375
<b>December 31, 2015:</b>			
Pay fixed / receive variable	\$ 4,317		440
Pay variable / receive fixed	4,317	440	
Total interest rate swap agreements	\$ 8,634	440	440

**NOTE 8: 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 six months ended June 30, 2016, there were no transfers between levels and no changes in valuation techniques for the Company's financial assets and liabilities.

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**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, benchmark yields, reported trades for similar securities, market consensus prepayment speeds, credit information, and the securities terms and conditions. On a quarterly basis, management reviews the pricing received from the third party pricing services for reasonableness given current market conditions. As part of its review, management may obtain non-binding third party broker quotes to validate the fair value measurements. In addition, management will periodically submit pricing provided by the third party pricing services to another independent valuation firm on a sample basis. This independent valuation firm will compare the price provided by the third party pricing service with its own price and will review the significant assumptions and valuation methodologies used with management.

*Interest rate swap agreements*

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

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The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of June 30, 2016 and December 31, 2015, respectively, by caption, on the accompanying consolidated balance sheets by ASC 820 valuation hierarchy (as described above).

	Amount	Quoted Prices in	Significant	
		Active Markets	Other	Significant
		for	Observable	Unobservable
		Identical Assets	Inputs	Inputs
		(Level 1)	(Level 2)	(Level 3)
<i>(Dollars in thousands)</i>				
<b>June 30, 2016:</b>				
Securities available-for-sale:				
Agency obligations	\$ 42,639		42,639	
Agency RMBS	102,879		102,879	
State and political subdivisions	71,484		71,484	
Total securities available-for-sale	217,002		217,002	
Other assets <sup>(1)</sup>	375		375	
<b>Total assets at fair value</b>	<b>\$ 217,377</b>		<b>217,377</b>	
Other liabilities <sup>(1)</sup>	\$ 375		375	
<b>Total liabilities at fair value</b>	<b>\$ 375</b>		<b>375</b>	
<b>December 31, 2015:</b>				
Securities available-for-sale:				
Agency obligations	\$ 60,085		60,085	
Agency RMBS	110,954		110,954	
State and political subdivisions	70,648		70,648	
Total securities available-for-sale	241,687		241,687	
Other assets <sup>(1)</sup>	440		440	

<b>Total assets at fair value</b>	\$	242,127	242,127
<b>Other liabilities<sup>(1)</sup></b>	\$	440	440
<b>Total liabilities at fair value</b>	\$	440	440

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

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

##### *Loans held for sale*

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

##### *Impaired Loans*

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

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

*Other real estate owned*

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

*Mortgage servicing rights, net*

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

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The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of June 30, 2016 and December 31, 2015, respectively, by caption, on the accompanying consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above):

	Carrying Amount	Quoted Prices in		
		Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>(Dollars in thousands)</i>				
<b>June 30, 2016:</b>				
Loans held for sale	\$ 1,567		1,567	
Loans, net <sup>(1)</sup>	2,556			2,556
Other real estate owned	300			300
Other assets <sup>(2)</sup>	2,146			2,146
Total assets at fair value	\$ 6,569		1,567	5,002
<b>December 31, 2015:</b>				
Loans held for sale	\$ 1,540		1,540	
Loans, net <sup>(1)</sup>	3,286			3,286
Other real estate owned	252			252
Other assets <sup>(2)</sup>	2,316			2,316
Total assets at fair value	\$ 7,394		1,540	5,854

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

<sup>(2)</sup>Represents MSR, net, carried at lower of cost or estimated fair value.

**Quantitative Disclosures for Level 3 Fair Value Measurements**

At June 30, 2016, 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 at June 30, 2016, the significant unobservable inputs used in the fair value measurements are presented below.

**Weighted**



(Dollars in thousands)	Carrying			Average
	Amount	Valuation Technique	Significant Unobservable Input	of Input
<b>Nonrecurring:</b>				
Impaired loans	\$ 2,556	Appraisal	Appraisal discounts (%)	50.2%
Other real estate owned	300	Appraisal	Appraisal discounts (%)	6.6%
Mortgage servicing rights, net	2,146	Discounted cash flow	Prepayment speed or CPR (%)	12.7%
			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.

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

***Loans, net***

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

***Loans held for sale***

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

***Time Deposits***

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

***Long-term debt***

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

The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company's financial instruments at June 30, 2016 and December 31, 2015 are presented below. This table excludes financial instruments for which the carrying amount approximates fair value. Financial assets for which fair value approximates carrying value included cash and cash equivalents. Financial liabilities for which fair value approximates carrying value included noninterest-bearing demand deposits, interest-bearing demand deposits, and savings deposits due to these products having no stated maturity. In addition, financial liabilities for which fair value approximates carrying value included overnight borrowings such as federal funds purchased and securities sold under agreements to repurchase.

	<b>Fair Value Hierarchy</b>				
	<b>Carrying amount</b>	<b>Estimated fair value</b>	<b>Level 1 inputs</b>	<b>Level 2 inputs</b>	<b>Level 3 Inputs</b>
<i>(Dollars in thousands)</i>					
<b>June 30, 2016:</b>					
Financial Assets:					
Loans, net (1)	\$ 426,166	\$ 439,452	\$	\$	\$ 439,452
Loans held for sale	1,567	1,600		1,600	
Financial Liabilities:					

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Time Deposits	\$	210,846	\$	212,291	\$		\$	212,291	\$
Long-term debt		7,217		7,217				7,217	

**December 31, 2015:**

Financial Assets:

Loans, net (1)	\$	422,121	\$	427,340	\$		\$		\$	427,340
Loans held for sale		1,540		1,574				1,574		

Financial Liabilities:

Time Deposits	\$	219,598	\$	220,093	\$		\$	220,093	\$
Long-term debt		7,217		7,217				7,217	

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

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### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

#### **General**

The following discussion and analysis is designed to provide a better understanding of various factors related to the results of operations and financial condition of Auburn National Bancorporation, Inc. (the Company) and its wholly owned subsidiary, AuburnBank (the Bank). This discussion is intended to supplement and highlight information contained in the accompanying unaudited condensed consolidated financial statements and related notes for the quarters and six months ended June 30, 2016 and 2015, as well as the information contained in our Annual Report on Form 10-K for the year ended December 31, 2015 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2016.

#### **Special Notice Regarding Forward-Looking Statements**

Certain of the statements made in this discussion and analysis and elsewhere, including information incorporated herein by reference to other documents, are forward-looking statements within the meaning of, and subject to, the protections of Section 27A of the Securities Act of 1933, as amended, (the Securities Act) and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act).

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause 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, show, indicate, would, believe, contemplate, expect, estimate, continue, plan, point to, project, could, similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation:

the effects of future economic, business, and market conditions and changes, domestic and foreign, including seasonality;

governmental monetary and fiscal policies;

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;

changes in accounting policies, rules, and practices;

the risks of changes in interest rates on the levels, composition, and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities, and the risks and uncertainty of the amounts realizable and the timing of dispositions of assets by the FDIC where we may have a participation or other interest;

changes in borrower credit risks and payment behaviors;

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;

changes in the prices, values, and sales volumes of residential and commercial real estate;

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

the failure of assumptions and estimates underlying the establishment of allowances for possible loan and other asset impairments, losses, and other estimates;

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

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

cyber attacks and data breaches that may compromise our systems or customers' information;

the failure of assumptions and estimates, as well as differences in, and changes to, economic, market, and credit conditions, including changes in borrowers' credit risks and payment behaviors from those used in our loan portfolio stress tests and other evaluations;

the risk that our deferred tax assets could be reduced if estimates of future taxable income from our operations and tax planning strategies are less than currently estimated, and sales of our capital stock could trigger a reduction in the amount of net operating loss carry-forwards that we may be able to utilize for income tax purposes; and

the other factors and information in this report and other filings that we make with the SEC under the Exchange Act, including our Annual Report on Form 10-K for the year ended December 31, 2015 and subsequent quarterly and current reports. See Part II, Item 1A. **RISK FACTORS** .

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

**Business**

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. In-store branches are located in the Kroger and Wal-Mart SuperCenter in Opelika. The Bank also operates a commercial loan production office in Phenix City, Alabama.

**Summary of Results of Operations**

<i>(Dollars in thousands, except per share amounts)</i>	<b>Quarter ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
Net interest income (a)	\$ 6,014	\$ 6,126	\$ 12,033	\$ 11,984

Less: tax-equivalent adjustment	322	338	644	673
Net interest income (GAAP)	5,692	5,788	11,389	11,311
Noninterest income	993	1,167	1,827	2,488
Total revenue	6,685	6,955	13,216	13,799
Provision for loan losses			(600)	
Noninterest expense	4,021	4,029	8,130	8,343
Income tax expense	733	776	1,564	1,444
Net earnings	\$ 1,931	\$ 2,150	\$ 4,122	\$ 4,012
Basic and diluted earnings per share	\$ 0.53	\$ 0.59	\$ 1.13	\$ 1.10

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

### Financial Summary

The Company's net earnings were \$4.1 million for the first six months of 2016, compared to \$4.0 million for the first six months of 2015. Basic and diluted earnings per share were \$1.13 per share for the first six months of 2016, compared to \$1.10 per share for the first six months of 2015.

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Net interest income (tax-equivalent) was \$12.0 million for the first six months of 2016 and 2015. Net interest income (tax-equivalent) for the first six months of 2015 included \$0.2 million in recoveries of interest related to payoffs received on two loans that were previously impaired. Excluding the impact of these interest recoveries, net interest income (tax-equivalent) increased 2% in the first six months of 2016 compared to the first six months of 2015. This increase was primarily due to a reduction in interest expense as the company lowered its deposit costs and repaid higher-cost wholesale funding sources. Average loans were \$432.2 million in the first six months of 2016, an increase of \$30.9 million or 8%, from the first six months of 2015. Average deposits were \$727.2 million in the first six months of 2016, an increase of \$24.6 million or 3%, from the first six months of 2015.

The Company recorded a negative provision for loan losses of \$0.6 million for the first six months of 2016, compared to no provision for loan losses for the first six months of 2015. Annualized net recoveries as a percent of average loans were 0.39% for the first six months of 2016 compared to 0.02% for the first six months of 2015. The Company recognized a recovery of \$1.2 million from the payoff of one nonperforming construction and land development loan during the first six months of 2016.

Noninterest income was \$1.8 million for the first six months of 2016, compared to \$2.5 million in the first six months of 2015. The decrease was primarily due to \$0.3 million in non-taxable death benefits from bank-owned life insurance that were received in the first six months of 2015, compared to none in the first six months of 2016, and a decrease in mortgage lending income of \$0.3 million as mortgage loan production declined.

Noninterest expense was \$8.1 million in the first six months of 2016, compared to \$8.3 million in the first six months of 2015. The decrease was primarily due to no prepayment penalties on long-term debt incurred in the first six months of 2016 compared to \$0.4 million incurred in the first six months of 2015 when the Company repaid \$5.0 million of long-term debt with an interest rate of 3.59%. This decrease was partially offset by a \$0.3 million increase in salaries and benefits due to routine annual increases.

Income tax expense was \$1.6 million for the first six months of 2016, compared to \$1.4 million for the first six months of 2015. The Company's income tax expense for the first six months of 2016 reflects an effective income tax rate of 27.51%, compared to 26.47% for the first six months of 2015. The increase in the effective tax rate is primarily due to a decrease in tax preference items such as income from bank-owned life insurance. The Company's effective income tax rate is principally impacted by tax-exempt earnings from the Company's investments in municipal securities and bank-owned life insurance.

In the first six months of 2016, the Company paid cash dividends of \$1.6 million, or \$0.45 per share. The Company's balance sheet remains well capitalized under current regulatory guidelines with a total risk-based capital ratio of 17.77% and a Tier 1 leverage ratio of 10.56% at June 30, 2016.

In the second quarter of 2016, net earnings were \$1.9 million, or \$0.53 per share, compared to \$2.2 million, or \$0.59 per share, for the second quarter of 2015. Net interest income (tax-equivalent) was \$6.0 million for the second quarter of 2016, compared to \$6.1 million for the second quarter of 2015. Net interest income (tax-equivalent) for the second quarter of 2015 included \$0.2 million in recoveries of interest related to payoffs received on two loans that were previously impaired. Excluding the impact of these interest recoveries, net interest income (tax-equivalent) increased 2% in the second quarter of 2016 compared to the second quarter of 2015. The Company recorded no provision for loan losses in the second quarter of 2016 and 2015. Noninterest income was \$1.0 million in the second quarter of 2016, compared to \$1.2 million in the second quarter of 2015. The decrease was primarily due to a decrease in mortgage lending income of \$0.1 million as mortgage loan production declined. Noninterest expense was \$4.0 million in the second quarter of 2016, unchanged compared to second quarter 2015. Income tax expense was approximately \$0.7 million for the second quarter of 2016 compared to \$0.8 million for the second quarter of 2015. The Company's



effective tax rate for the second quarter of 2016 was 27.57%, compared to 26.52% in the second quarter of 2015. Despite the increase in the effective tax rate, income tax expense decreased due to a decrease in earnings before taxes.

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### **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, the impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

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

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

As part of the Company's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment. 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 each loan segment. 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 Company calculates average losses for all loan segments using a rolling 20 quarter historical period. 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 June 30, 2016 and December 31, 2015, and for the periods then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

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

### **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 8, 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.

**Table of Contents****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 June 30, 2016. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

**RESULTS OF OPERATIONS****Average Balance Sheet and Interest Rates**

	<b>Six Months Ended June 30,</b>			
	<b>2016</b>		<b>2015</b>	
	<b>Average</b>	<b>Yield/</b>	<b>Average</b>	<b>Yield/</b>
<i>(Dollars in thousands)</i>	<b>Balance</b>	<b>Rate</b>	<b>Balance</b>	<b>Rate</b>
Loans and loans held for sale	\$ 433,504	4.76%	\$ 404,106	5.10%
Securities - taxable	162,980	2.06%	193,694	2.07%
Securities - tax-exempt	67,271	5.66%	68,115	5.86%
Total securities	230,251	3.11%	261,809	3.06%
Federal funds sold	57,702	0.50%	60,789	0.21%
Interest bearing bank deposits	57,023	0.49%	24,449	0.23%

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Total interest-earning assets	778,480	3.65%	751,153	3.83%
Deposits:				
NOW	123,831	0.31%	114,739	0.31%
Savings and money market	227,772	0.38%	207,027	0.40%
Certificates of deposits less than \$100,000	82,794	0.97%	93,933	1.06%
Certificates of deposits and other time deposits of \$100,000 or more	132,336	1.41%	145,124	1.45%
Total interest-bearing deposits	566,733	0.69%	560,823	0.76%
Short-term borrowings	2,836	0.50%	4,167	0.48%
Long-term debt	7,217	3.54%	9,372	3.53%
Total interest-bearing liabilities	576,786	0.73%	574,362	0.81%
Net interest income and margin (tax-equivalent)	\$ 12,033	3.11%	\$ 11,984	3.22%

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**Table of Contents****Net Interest Income and Margin**

Net interest income (tax-equivalent) was \$12.0 million for the first six months of 2016 and 2015. Net interest income (tax-equivalent) for the first six months of 2015 included \$0.2 million in recoveries of interest related to payoffs received on two loans that were previously impaired. Excluding the impact of these interest recoveries, net interest income (tax-equivalent) increased 2% in the first six months of 2016 compared to the first six months of 2015. This increase reflects management's ongoing efforts to increase earnings by shifting the Company's asset mix through loan growth, focusing on deposit pricing, and repaying higher-cost wholesale funding.

The tax-equivalent yield on total interest-earning assets decreased by 18 basis points in the first six months of 2016 from the first six months of 2015 to 3.65%. This decrease was primarily due to declining yields on loans and increased pricing competition for quality loan opportunities in our markets, which has limited the Company's ability to increase yields on new and renewed loans.

The cost of total interest-bearing liabilities decreased 8 basis points in the first six months of 2016 from the first six months of 2015 to 0.73%. The net decrease was largely a result of the continued shift in our funding mix, as we increased our lower-cost interest bearing demand deposits (NOW accounts), and savings and money market accounts and concurrently reduced balances of higher-cost certificates of deposits and long-term debt.

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

**Provision for Loan Losses**

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that management believes, based on its processes and estimates, should be adequate to provide for the probable losses on outstanding loans. The Company recorded a negative provision for loan losses of \$0.6 million in the first six months of 2016 as a result of a \$1.2 million recovery from the payoff of a non-performing construction and land development loan. No provision for loan losses was made for the first six months of 2015. Provision expense reflects the absolute level of loans, loan growth, the credit quality of the loan portfolio, and the amount of net charge-offs or recoveries.

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes should be appropriate to adequately cover its estimate of probable losses in the loan portfolio. The Company's allowance for loan losses as a percentage of total loans was 1.05% at June 30, 2016, compared to 1.01% at December 31, 2015. While the policies and procedures used to estimate the allowance for loan losses, as well as the resulting provision for loan losses charged to operations, are considered adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgments and are therefore approximate and imprecise. Factors beyond our control (such as conditions in the local and national economy, local real estate markets, or industry) may have a material adverse effect on our asset quality and the adequacy of our allowance for loan losses resulting in significant increases in the provision for loan losses.

**Noninterest Income****Six Months Ended June 30,**



**Quarter ended June 30,**

<i>(Dollars in thousands)</i>	<b>2016</b>		<b>2015</b>	
Service charges on deposit accounts	\$	193	\$	209
Mortgage lending income		315		457
Bank-owned life insurance		113		112
Securities gains, net				225
Other		372		389
				717
Total noninterest income	\$	993	\$	1,167
				1,827
				\$ 2,488

Service charges on deposit accounts decreased primarily due to a decline in insufficient funds charges, reflecting changes in customer behavior and spending patterns.

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

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

MSRs are also evaluated for impairment 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.

	Quarter ended June 30,		Six Months Ended June 30,	
<i>(Dollars in thousands)</i>	2016	2015	2016	2015
Origination income	\$ 270	\$ 386	\$ 367	\$ 644
Servicing fees, net	46	22	128	108
(Increase) decrease in MSR valuation allowance	(1)	49	(1)	39
Total mortgage lending income	\$ 315	\$ 457	\$ 494	\$ 791

The decrease in mortgage lending income was primarily due to a decrease in the volume of mortgage loans originated and sold. The decrease in volume is due to various factors, including the Company's efforts to comply with the new TILA-RESPA Integrated Disclosure (TRID) rules and a reduction in the number of mortgage originators. Until the Company's new loan origination system is fully implemented and operational, management expects mortgage lending income and volume will decrease compared to prior periods. The Company is in the implementation phase of this new system.

Income from bank-owned life insurance decreased in the first six months of 2016, compared to the first six months of 2015 due to non-taxable death benefits received in the prior year. The assets that support these policies are administered by the life insurance carriers and the income we receive (i.e. increases or decreases in the cash surrender value of the policies) on these policies is dependent upon the returns the insurance carriers are able to earn on the underlying investments that support these policies. Earnings on these policies are generally not taxable.

**Noninterest Expense**

	Quarter ended June 30,		Six Months Ended June 30,	
<i>(Dollars in thousands)</i>	2016	2015	2016	2015
Salaries and benefits	\$ 2,446	\$ 2,291	\$ 4,851	\$ 4,559
Net occupancy and equipment	358	362	718	720
Professional fees	194	218	405	419
FDIC and other regulatory assessments	122	118	244	243
Other real estate owned, net	(43)	1	(23)	18
Prepayment penalty on long-term debt				362
Other	944	1,039	1,935	2,022
Total noninterest expense	\$ 4,021	\$ 4,029	\$ 8,130	\$ 8,343

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

During the first six months of 2015, the Company repaid \$5.0 million of long-term debt with an interest rate of 3.59% and incurred prepayment penalties of \$0.4 million.

**Table of Contents****Income Tax Expense**

Income tax expense was \$1.6 million for the first six months of 2016, compared to \$1.4 million for the first six months of 2015. The Company's income tax expense for the first six months of 2016 reflects an effective income tax rate of 27.51%, compared to 26.47% for the first six months of 2015. The increase in the effective tax rate is primarily due to a decrease in tax preference items such as income from bank-owned life insurance. The Company's income tax expense is principally affected by tax exempt earnings on municipal securities investments and bank-owned life insurance.

**BALANCE SHEET ANALYSIS****Securities**

Securities available-for-sale were \$217.0 million at June 30, 2016, a decrease of \$24.7 million, or 10%, compared to \$241.7 million at December 31, 2015. This decline was primarily due to a decrease of \$30.9 million in the amortized cost basis of securities available-for-sale from principal repayments, maturities and calls. This decrease was offset by securities purchases of \$3.2 million and a \$3.8 million change in net unrealized gains on securities available-for-sale, reflecting an increase in prices as long-term interest rates declined during the first six months of 2016.

The average tax-equivalent yields earned on total securities were 3.11% in the first six months of 2016 and 3.06% in the first six months of 2015.

**Loans**

	2016		2015		
	Second	First	Fourth	Third	Second
	Quarter	Quarter	Quarter	Quarter	Quarter
<i>(In thousands)</i>					
Commercial and industrial	\$ 50,190	50,192	52,479	47,925	57,310
Construction and land development	49,346	45,953	43,694	41,592	38,854
Commercial real estate	208,825	209,320	203,853	201,449	184,124
Residential real estate	113,763	117,046	116,673	117,863	115,039
Consumer installment	9,125	9,769	10,220	14,362	13,632
Total loans	431,249	432,280	426,919	423,191	408,959
Less: unearned income	(555)	(517)	(509)	(619)	(464)
Loans, net of unearned income	\$ 430,694	431,763	426,410	422,572	408,495

Total loans, net of unearned income, were \$430.7 million at June 30, 2016, compared to \$426.4 million at December 31, 2015. Four loan categories represented the majority of the loan portfolio at June 30, 2016: commercial real estate (49%), residential real estate (26%), construction and land development (11%) and commercial and industrial (12%). Approximately 23% of the Company's commercial real estate loans were classified as owner-occupied at June 30, 2016.

Within the residential real estate portfolio segment, the Company had junior lien mortgages of approximately \$14.7 million, or 3% of total loans, at June 30, 2016, compared to \$16.4 million, or 4% of total loans, at December 31, 2015. For residential real estate mortgage loans with a consumer purpose, \$1.6 million required interest-only payments at June 30, 2016, compared to \$0.9 million at December 31, 2015. 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.

The average yield earned on loans and loans held for sale was 4.76% in the first six months of 2016 and 5.10% in the first six months of 2015.

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, availability and cost of financing 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.

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The Company attempts to reduce these economic and credit risks by adhering to loan to value guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers' financial position. Also, we have established and periodically review, lending policies and procedures. Banking regulations limit a bank's credit exposure by prohibiting unsecured loan relationships that exceed 10% of its capital; or 20% of capital, if loans in excess of 10% of capital are fully secured. Under these regulations, we are prohibited from having secured loan relationships in excess of approximately \$18.1 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$16.3 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At June 30, 2016, the Bank had no loan relationships exceeding these limits.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any one or more industries. We use classification systems broadly accepted by the financial services industry in order to categorize our commercial borrowers. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank's total risk-based capital at June 30, 2016 (and related balances at December 31, 2015).

	<b>June 30,</b>	<b>December 31,</b>
<i>(In thousands)</i>	<b>2016</b>	<b>2015</b>
Lessors of 1 to 4 family residential properties	\$ 45,686	\$ 46,664
Multi-family residential properties	43,279	45,264
Shopping centers	38,190	38,116

**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 inherent in the loan portfolio. At June 30, 2016 and December 31, 2015, the allowance for loan losses was \$4.5 million and \$4.3 million, respectively, which management believed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under Critical Accounting Policies.

A summary of the changes in the allowance for loan losses and certain asset quality ratios for the second quarter of 2016 and the previous four quarters is presented below.

	<b>2016</b>		<b>2015</b>		
	<b>Second</b>	<b>First</b>	<b>Fourth</b>	<b>Third</b>	<b>Second</b>
<i>(Dollars in thousands)</i>	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>

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Balance at beginning of period	\$ 4,774	4,289	5,127	4,886	4,722
Charge-offs:					
Commercial and industrial	(83)		(42)		
Commercial real estate	(194)		(866)		
Residential real estate	(37)	(118)	(3)	(26)	
Consumer installment	(2)	(26)	(14)	(23)	(5)
Total charge-offs	(316)	(144)	(925)	(49)	(5)
Recoveries	70	1,229	87	90	169
Net (charge-offs) recoveries	(246)	1,085	(838)	41	164
Provision for loan losses		(600)		200	
Ending balance	\$ 4,528	4,774	4,289	5,127	4,886
as a % of loans	1.05 %	1.11	1.01	1.21	1.20
as a % of nonperforming loans	271 %	246	158	140	360
Net charge-offs (recoveries) as % of average loans (a)	0.23 %	(1.01)	0.79	(0.04)	(0.16)

(a) Net charge-offs (recoveries) are annualized.

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As described 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 loss rates, and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments, including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.05% at June 30, 2016, compared to 1.01% at December 31, 2015. 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. In addition, our regulators, as an integral part of their examination process, will 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.

Net recoveries were \$839 thousand, or 0.39% of average loans in the first six months of 2016, compared to net recoveries of \$50,000, or 0.02% of average loans in the first six months of 2015. In the first six months of 2016, the Company recognized a recovery of \$1.2 million from the payoff of one nonperforming construction and land development loan.

At June 30, 2016, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 271%, compared to 158% at December 31, 2015. The increase was primarily due to a decrease in nonperforming loans of \$1.0 million.

At June 30, 2016 and December 31, 2015, the Company's recorded investment in loans considered impaired was \$2.7 million and \$3.4 million, respectively, with corresponding valuation allowances (included in the allowance for loan losses) of \$0.1 million at each respective date.

**Nonperforming Assets**

At June 30, 2016 and December 31, 2015, respectively, the Company had \$2.0 million and \$3.0 million in nonperforming assets. The decrease was primarily due to the payoff of one nonperforming construction and land development loan with a recorded investment of \$0.5 million at December 31, 2015.

The table below provides information concerning total nonperforming assets and certain asset quality ratios for the second quarter of 2016 and the previous four quarters.

	2016			2015	
	Second	First	Fourth	Third	Second
	Quarter	Quarter	Quarter	Quarter	Quarter
<i>(Dollars in thousands)</i>					
<b>Nonperforming assets:</b>					
Nonaccrual loans	\$ 1,669	1,938	2,714	3,650	1,359



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Other real estate owned		300	397	252	278	499
Total nonperforming assets	\$	1,969	2,335	2,966	3,928	1,858
as a % of loans and other real estate owned		0.46 %	0.54	0.70	0.93	0.45
as a % of total assets		0.23 %	0.28	0.36	0.48	0.23
Nonperforming loans as a % of total loans		0.39 %	0.45	0.64	0.86	0.33
Accruing loans 90 days or more past due	\$				112	442

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The table below provides information concerning the composition of nonaccrual loans for the second quarter of 2016 and the previous four quarters.

<i>(In thousands)</i>	2016			2015	
	Second	First	Fourth	Third	Second
	Quarter	Quarter	Quarter	Quarter	Quarter
<b>Nonaccrual loans:</b>					
Commercial and industrial	\$ 40	42	43	81	46
Construction and land development	55	66	583	594	602
Commercial real estate	1,564	1,734	1,750	2,790	684
Residential real estate	10	96	325	185	27
Consumer installment			13		
<b>Total nonaccrual loans</b>	<b>\$ 1,669</b>	<b>1,938</b>	<b>2,714</b>	<b>3,650</b>	<b>1,359</b>

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is 90 days or more past due, unless the loan is both well-secured and in the process of collection. At June 30, 2016 and December 31, 2015, respectively, the Company had \$1.7 million and \$2.7 million in loans on nonaccrual.

At June 30, 2016 and December 31, 2015, there were no loans 90 days or more past due and still accruing.

The table below provides information concerning the composition of other real estate owned for the second quarter of 2016 and the previous four quarters.

<i>(In thousands)</i>	2016			2015	
	Second	First	Fourth	Third	Second
	Quarter	Quarter	Quarter	Quarter	Quarter
<b>Other real estate owned:</b>					
Commercial:					
Developed lots	\$ 252	252	252	252	252
Residential	48	145		26	247

Total other real estate owned	\$	300	397	252	278	499
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At June 30, 2016 and December 31, 2015, respectively, the Company held \$0.3 million, respectively, in OREO, which we acquired from borrowers.

### Potential Problem Loans

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of a borrower have 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 \$5.5 million, or 1.3% of total loans at June 30, 2016, compared to \$5.9 million, or 1.4% of total loans at December 31, 2015.

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The table below provides information concerning the composition of potential problem loans for the second quarter of 2016 and the previous four quarters.

	2016			2015	
	Second	First	Fourth	Third	Second
<i>(In thousands)</i>	Quarter	Quarter	Quarter	Quarter	Quarter
<b>Potential problem loans:</b>					
Commercial and industrial	\$ 285	309	323	329	383
Construction and land development	365	477	593	578	627
Commercial real estate	911	783	491	501	503
Residential real estate	3,855	3,938	4,371	4,964	4,898
Consumer installment	84	110	114	128	167
<b>Total potential problem loans</b>	<b>\$ 5,500</b>	<b>5,617</b>	<b>5,892</b>	<b>6,500</b>	<b>6,578</b>

At June 30, 2016, approximately \$0.1 million, or 2.0%, of total potential problem loans were past due at least 30 days, but less than 90 days. At June 30, 2016, the remaining balance of potential problem loans were current or past due less than 30 days.

The following table is a summary of the Company's performing loans that were past due at least 30 days, but less than 90 days, for the second quarter of 2016 and the previous four quarters.

	2016			2015	
	Second	First	Fourth	Third	Second
<i>(In thousands)</i>	Quarter	Quarter	Quarter	Quarter	Quarter

**Quarter**

<b>Performing loans past due 30 to 89 days:</b>						
Commercial and industrial	\$	25	14	49	37	6
Construction and land development			129			12
Commercial real estate					182	
Residential real estate		645	623	1,334	335	415
Consumer installment		51	28	28	20	23
<b>Total</b>	<b>\$</b>	<b>721</b>	<b>794</b>	<b>1,411</b>	<b>574</b>	<b>456</b>

**Deposits**

Total deposits were \$747.5 million at June 30, 2016, compared to \$723.6 million at December 31, 2015. Noninterest bearing deposits were \$167.7 million, or 22.4% of total deposits, at June 30, 2016, compared to \$156.8 million, or 21.7% of total deposits at December 31, 2015.

The average rate paid on total interest-bearing deposits was 0.69% in the first six months of 2016 and 0.76% in the first six months of 2015.

**Other Borrowings**

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity less than one year. The Bank had available federal funds lines totaling \$41.0 million with none outstanding at June 30, 2016, and at December 31, 2015, respectively. Securities sold under agreements to repurchase totaled \$2.6 million and \$3.0 million at June 30, 2016 and December 31, 2015, respectively.

The average rate paid on short-term borrowings was 0.50% in the first six months of 2016 and 0.48% in the first six months of 2015.

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Long-term debt includes FHLB advances with an original maturity greater than one year and subordinated debentures related to trust preferred securities. The Bank had no long-term FHLB advances outstanding and \$7.2 million in junior subordinated debentures related to trust preferred securities outstanding at June 30, 2016 and December 31, 2015, respectively. The debentures mature on December 31, 2033 and have been redeemable since December 31, 2008.

The average rate paid on long-term debt was 3.54% in the first six months of 2016 and 3.53% in the first six months of 2015.

**CAPITAL ADEQUACY**

The Company's consolidated stockholders' equity was \$84.8 million and \$79.9 million as of June 30, 2016 and December 31, 2015, respectively. The change from December 31, 2015 was primarily driven by net earnings of \$4.1 million and other comprehensive income due to the change in unrealized gains (losses) on securities available-for-sale, net-of-tax, of \$2.4 million, partially offset by cash dividends paid of \$1.6 million.

On January 1, 2015, the Company and Bank became subject to the rules of the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The new rules included the implementation of a new capital conservation buffer that is added to the minimum requirements for capital adequacy purposes. The capital conservation buffer is subject to a three year phase-in period that began on January 1, 2016 and will be fully phased-in on January 1, 2019 at 2.5%. The required phase-in capital conservation buffer during 2016 is 0.625%. A banking organization with a conservation buffer of less than the required amount will be subject to limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. At June 30, 2016, the ratios for the Company and Bank were sufficient to meet the fully phased-in conservation buffer.

The Company's tier 1 leverage ratio was 10.56%, common equity tier 1 ( CET1 ) risk-based capital ratio was 15.54%, tier 1 risk-based capital ratio was 16.87%, and total risk-based capital ratio was 17.77% at June 30, 2016. 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. The Company's capital conservation buffer was 9.77% at June 30, 2016.

**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. ALCO measures and evaluates interest rate risk so that the Bank can meet customer demands for various types of loans and deposits. Measurements used to help manage interest rate sensitivity include an earnings simulation model and an economic value of equity ( EVE ) model.

**Earnings simulation.** Management believes that interest rate risk is best estimated by our earnings simulation modeling. 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

At June 30, 2016, our earnings simulation model indicated that we were in compliance with the policy guidelines noted above.

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***Economic Value of Equity.*** EVE measures the extent that the 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

At June 30, 2016, 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 a 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 June 30, 2016 and December 31, 2015, the Company had no derivative contracts designated as part of a hedging relationship to assist in managing its 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 legal entities with different funding needs and sources, and each are subject to regulatory guidelines and requirements.

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

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Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, sales of securities, and the 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 may participate in the FHLB's advance program to obtain funding for its growth. Advances include both fixed and variable terms and may be taken out with varying maturities. At June 30, 2016, the Bank had a remaining available line of credit with the FHLB of \$245.9 million. At June 30, 2016, the Bank also had \$41.0 million of available federal funds lines with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

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 twelve months.

## **Off-Balance Sheet Arrangements, Commitments and Contingencies**

At June 30, 2016, the Bank had outstanding standby letters of credit of \$7.0 million and unfunded loan commitments outstanding of \$53.0 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 could liquidate federal funds sold or a portion of securities available-for-sale, or draw on its available credit facilities.

### *Mortgage lending activities*

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

As of June 30, 2016, the unpaid principal balance of residential mortgage loans, which we have originated and sold, but retained the servicing rights was \$349.6 million. Although these loans are generally sold on a non-recourse basis, we may be obligated to repurchase residential mortgage loans or reimburse investors for losses incurred (make whole requests) if a loan review reveals a potential breach of seller representations and warranties. Upon receipt of a repurchase or make whole request, we work with investors to arrive at a mutually agreeable resolution. Repurchase and make whole requests 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 or make whole event has occurred. We seek to reduce and manage the risks of potential repurchases, make whole requests, or other claims by mortgage loan investors through our underwriting and quality assurance practices and by servicing mortgage loans to meet investor and secondary market standards.

In the first six months of 2016, as a result of the representation and warranty provisions contained in the Company's sale agreements with Fannie Mae, the Company was required to repurchase one loan with a principal balance of \$198,000 that was current as to principal and interest at the time of repurchase. At June 30, 2016, the Company had no pending repurchase or make whole requests.

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.

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Although repurchase and make whole requests related to representation and warranty provisions and servicing activities have been limited to date, it is possible that requests to repurchase mortgage loans or reimburse investors for losses incurred (make whole requests) may increase in frequency if investors more aggressively pursue all means of recovering losses on their purchased loans. As of June 30, 2016, we do not believe that this exposure is material due to the historical level of repurchase requests and loss trends, in addition to 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 U.S. generally accepted accounting principles and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

## **CURRENT ACCOUNTING DEVELOPMENTS**

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

ASU 2014-09, *Revenue from Contracts with Customers*;

ASU 2015-14, *Revenue from Contracts with Customers – Deferral of the Effective Date*;

ASU 2016-01, *Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*;

ASU 2016-02, *Leases*; and

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

Information about these pronouncements is described in more detail below.

ASU 2014-09, *Revenue from Contracts with Customers*, provides a comprehensive and converged standard on revenue recognition. The new guidance is intended to improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects consideration to which the entity expects to be entitled in exchange for those goods and services. This guidance also requires new qualitative and quantitative disclosures related to revenue from contracts with customers. In August 2015, FASB issued ASU 2015-14, *Revenue from Contracts with Customers – Deferral of the Effective Date*, which defers the effective date by one year. With the deferral, these changes are effective for the Company in the first quarter of 2018 with retrospective application to each prior reporting period or with the cumulative effect of initially applying this Update at the date of initial application. Early adoption is not permitted. The Company is currently evaluating the

impact this ASU will have on its consolidated financial statements.

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ASU 2016-01, *Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Some of the amendments include the following: 1) Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; 2) Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; 4) Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others. For public business entities, the amendments of this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact of this ASU will have on its consolidated financial statements.

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 lease term. The new guidance is effective for annual and interim reporting periods beginning after December 15, 2018. The amendment should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of the new guidance on its consolidated financial statements.

ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): - Measurement of Credit Losses on Financial Instruments*, amends guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. For assets held at amortized cost basis, the new standard eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses using a broader range of information regarding past events, current conditions and forecasts assessing the collectability of cash flows. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. For available for sale debt securities, credit losses should be measured in a manner similar to current GAAP, however the new standard will require that credit losses be presented as an allowance rather than as a write-down. The new guidance affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. For public business entities that are SEC filers, the new guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2019 early adoption is permitted beginning in 2019. The Company is currently evaluating the impact of the new guidance on its consolidated financial statements.

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

In addition to results presented in accordance with U.S. generally accepted accounting principles (GAAP), this quarterly report on Form 10-Q includes certain designated net interest income amounts presented on a tax-equivalent basis, a non-GAAP financial measure, including the presentation and 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 reconciliations of these non-GAAP financial measures to their most directly comparable GAAP financial measures are presented below.

		2016			2015	
		Second	First	Fourth	Third	Second
		Quarter	Quarter	Quarter	Quarter	Quarter
<i>(In thousands)</i>						
<b>Net interest income (GAAP)</b>	\$	5,692	5,697	5,737	5,670	5,788
Tax-equivalent adjustment		322	322	328	341	338
<b>Net interest income (Tax-equivalent)</b>	\$	6,014	6,019	6,065	6,011	6,126

		Six Months Ended June 30,	
		2016	2015
<i>(In thousands)</i>			
<b>Net interest income (GAAP)</b>	\$	11,389	11,311
Tax-equivalent adjustment		644	673
<b>Net interest income (Tax-equivalent)</b>	\$	12,033	11,984

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

	2016			2015	
	Second	First	Fourth	Third	Second
<i>(Dollars in thousands, except per share amounts)</i>	Quarter	Quarter	Quarter	Quarter	Quarter
<b>Results of Operations</b>					
Net interest income (a)	\$ 6,014	6,019	6,065	6,011	6,126
Less: tax-equivalent adjustment	322	322	328	341	338
Net interest income (GAAP)	5,692	5,697	5,737	5,670	5,788
Noninterest income	993	834	988	1,056	1,167
Total revenue	6,685	6,531	6,725	6,726	6,955
Provision for loan losses		(600)		200	
Noninterest expense	4,021	4,109	4,137	3,892	4,029
Income tax expense	733	831	652	724	776
Net earnings	\$ 1,931	2,191	1,936	1,910	2,150
<b>Per share data:</b>					
Basic and diluted net earnings	\$ 0.53	0.60	0.53	0.52	0.59
Cash dividends declared	0.225	0.225	0.22	0.22	0.22
Weighted average shares outstanding:					
Basic and diluted	3,643,503	3,643,484	3,643,478	3,643,455	3,643,413
Shares outstanding	3,643,503	3,643,503	3,643,478	3,643,478	3,643,428
Book value	\$ 23.28	22.75	21.94	21.85	21.15
Common stock price					
High	\$ 29.85	30.49	30.39	27.80	25.75
Low	26.81	24.56	26.14	25.78	24.51
Period end	28.49	28.25	29.62	26.47	25.73
To earnings ratio	13.07x	12.61	13.78	12.37	12.08
To book value	122%	124	135	121	122
<b>Performance ratios:</b>					
Return on average equity	9.18%	10.82	9.59	9.75	10.91
Return on average assets	0.93%	1.07	0.95	0.95	1.09
Dividend payout ratio	42.45%	37.50	41.51	42.31	37.29
<b>Asset Quality:</b>					
Allowance for loan losses as a % of:					
Loans	1.05%	1.11	1.01	1.21	1.20
Nonperforming loans	271%	246	158	140	360
Nonperforming assets as a % of:					



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Loans and other real estate owned	0.46%	0.54	0.70	0.93	0.45
Total assets	0.23%	0.28	0.36	0.48	0.23
Nonperforming loans as a % of total loans	0.39%	0.45	0.64	0.86	0.33
Net charge-offs (recoveries) as a % of average loans (c)	0.23%	(1.01)	0.79	(0.04)	(0.16)
<b>Capital Adequacy:</b>					
CET 1 risk-based capital ratio	15.54%	15.36	15.28	15.01	15.42
Tier 1 risk-based capital ratio	16.87%	16.69	16.57	16.29	16.76
Total risk-based capital ratio	17.77%	17.64	17.44	17.33	17.78
Tier 1 Leverage Ratio	10.56%	10.47	10.35	10.37	10.39
<b>Other financial data:</b>					
Net interest margin (a)	3.10%	3.12	3.12	3.13	3.29
Effective income tax rate	27.52%	27.50	25.19	27.49	26.52
Efficiency ratio (b)	57.39%	59.96	58.66	55.07	55.24
<b>Selected average balances:</b>					
Securities	\$ 223,414	237,087	246,130	251,393	259,376
Loans, net of unearned income	434,934	429,528	426,192	416,210	402,482
Total assets	828,106	821,382	815,616	806,764	791,889
Total deposits	727,989	726,354	720,854	714,960	699,453
Long-term debt	7,217	7,217	7,217	7,217	7,217
Total stockholders equity	84,124	80,965	80,764	78,387	78,791
<b>Selected period end balances:</b>					
Securities	\$ 217,002	234,109	241,687	250,142	252,906
Loans, net of unearned income	430,694	431,763	426,410	422,572	408,495
Allowance for loan losses	4,528	4,774	4,289	5,127	4,886
Total assets	846,056	833,328	817,189	817,994	806,233
Total deposits	747,539	737,361	723,627	724,311	715,994
Long-term debt	7,217	7,217	7,217	7,217	7,217
Total stockholders equity	84,808	82,887	79,949	79,599	77,053

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

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

(c) Net charge-offs (recoveries) are annualized.

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

	<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>
<i>(Dollars in thousands, except per share amounts)</i>		
<b>Results of Operations</b>		
Net interest income (a)	\$ 12,033	11,984
Less: tax-equivalent adjustment	644	673
Net interest income (GAAP)	11,389	11,311
Noninterest income	1,827	2,488
Total revenue	13,216	13,799
Provision for loan losses	(600)	
Noninterest expense	8,130	8,343
Income tax expense	1,564	1,444
Net earnings	\$ 4,122	4,012
<b>Per share data:</b>		
Basic and diluted net earnings	\$ 1.13	1.10
Cash dividends declared	0.45	0.44
Weighted average shares outstanding:		
Basic and diluted	3,643,493	3,643,389
Shares outstanding, at period end	3,643,503	3,643,428
Book value	\$ 23.28	21.15
Common stock price		
High	\$ 30.49	25.75
Low	24.56	23.15
Period end	28.49	25.73
To earnings ratio	13.07x	12.08
To book value	122%	122
<b>Performance ratios:</b>		
Return on average equity	9.99%	10.31
Return on average assets	1.00%	1.01
Dividend payout ratio	39.82%	40.00
<b>Asset Quality:</b>		
Allowance for loan losses as a % of:		
Loans	1.05%	1.20
Nonperforming loans	271%	360
Nonperforming assets as a % of:		
Loans and other real estate owned	0.46%	0.45
Total assets	0.23%	0.23
Nonperforming loans as a % of total loans	0.39%	0.33
Annualized net recoveries as a % of average loans	(0.39)%	(0.02)
<b>Capital Adequacy:</b>		
CET 1 risk-based capital ratio	15.54%	15.42
Tier 1 risk-based capital ratio	16.87%	16.76

Total risk-based capital ratio	17.77%	17.78
Tier 1 Leverage Ratio	10.56%	10.39
<b>Other financial data:</b>		
Net interest margin (a)	3.11%	3.22
Effective income tax rate	27.51%	26.47
Efficiency ratio (b)	58.66%	57.65
<b>Selected average balances:</b>		
Securities	\$ 230,251	261,809
Loans, net of unearned income	432,231	401,327
Total assets	823,054	796,947
Total deposits	727,171	702,582
Long-term debt	7,217	9,372
Total stockholders' equity	82,545	77,858
<b>Selected period end balances:</b>		
Securities	\$ 217,002	252,906
Loans, net of unearned income	430,694	408,495
Allowance for loan losses	4,528	4,886
Total assets	846,056	806,233
Total deposits	747,539	715,994
Long-term debt	7,217	7,217
Total stockholders' equity	84,808	77,053

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

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

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

	Quarter ended June 30,						
	2016			2015			
		Interest		Interest			
	Average	Income/	Yield/	Average	Income/	Yield/	
<i>(Dollars in thousands)</i>	Balance	Expense	Rate	Balance	Expense	Rate	
<b>Interest-earning assets:</b>							
Loans and loans held for sale (1)	\$ 436,462	\$ 5,172	4.77%	\$ 405,093	\$ 5,217	5.17%	
Securities - taxable	155,835	775	2.00%	191,181	949	1.99%	
Securities - tax-exempt (2)	67,580	945	5.62%	68,195	992	5.83%	
Total securities	223,415	1,720	3.10%	259,376	1,941	3.00%	
Federal funds sold	56,989	72	0.51%	47,215	28	0.24%	
Interest bearing bank deposits	64,062	84	0.53%	35,370	23	0.26%	
Total interest-earning assets	780,928	\$ 7,048	3.63%	747,054	\$ 7,209	3.87%	
Cash and due from banks	12,614			13,083			
Other assets	34,564			31,752			
Total assets	\$ 828,106			\$ 791,889			
<b>Interest-bearing liabilities:</b>							
Deposits:							
NOW	\$ 125,512	\$ 97	0.31%	\$ 114,803	\$ 88	0.31%	
Savings and money market	225,678	212	0.38%	202,309	183	0.36%	
Certificates of deposits less than \$100,000	81,582	201	0.99%	92,423	238	1.03%	
Certificates of deposits and other time deposits of \$100,000 or more	131,252	457	1.40%	142,526	511	1.44%	

Total interest-bearing deposits	564,024	967	0.69%	552,061	1,020	0.74%
Short-term borrowings	2,517	3	0.48%	3,678	4	0.44%
Long-term debt	7,217	64	3.57%	7,217	59	3.28%
<b>Total interest-bearing liabilities</b>	<b>573,758</b>	<b>\$ 1,034</b>	<b>0.72%</b>	<b>562,956</b>	<b>\$ 1,083</b>	<b>0.77%</b>
Noninterest-bearing deposits	163,965			147,392		
Other liabilities	6,259			2,750		
Stockholders equity	84,124			78,791		
<b>Total liabilities and stockholders equity</b>	<b>\$ 828,106</b>			<b>\$ 791,889</b>		
Net interest income and margin (tax-equivalent)		\$ 6,014	3.10%		\$ 6,126	3.29%

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

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

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

	<b>Six Months Ended June 30,</b>					
	Average	<b>2016</b>	Yield/	Average	<b>2015</b>	Yield/
<i>(Dollars in thousands)</i>	Balance	Interest Income/ Expense	Rate	Balance	Interest Expense	Rate
<b>Interest-earning assets:</b>						
Loans and loans held for sale (1)	\$ 433,504	\$ 10,268	4.76%	\$ 404,106	\$ 10,223	5.10%
Securities - taxable	162,980	1,673	2.06%	193,694	1,989	2.07%
Securities - tax-exempt (2)	67,271	1,892	5.66%	68,115	1,978	5.86%
Total securities	230,251	3,565	3.11%	261,809	3,967	3.06%
Federal funds sold	57,702	143	0.50%	60,789	62	0.21%
Interest bearing bank deposits	57,023	139	0.49%	24,449	28	0.23%
Total interest-earning assets	778,480	\$ 14,115	3.65%	751,153	\$ 14,280	3.83%
Cash and due from banks	12,867			13,439		
Other assets	31,707			32,355		
Total assets	\$ 823,054			\$ 796,947		
<b>Interest-bearing liabilities:</b>						
<b>Deposits:</b>						
NOW	\$ 123,831	\$ 191	0.31%	\$ 114,739	\$ 174	0.31%
Savings and money market	227,772	431	0.38%	207,027	409	0.40%
Certificates of deposits less than \$100,000	82,794	401	0.97%	93,933	492	1.06%
Certificates of deposits and other time deposits of \$100,000 or more	132,336	925	1.41%	145,124	1,047	1.45%
Total interest-bearing deposits	566,733	1,948	0.69%	560,823	2,122	0.76%
Short-term borrowings	2,836	7	0.50%	4,167	10	0.48%
Long-term debt	7,217	127	3.54%	9,372	164	3.53%

Total interest-bearing liabilities	576,786	\$	2,082	0.73%	574,362	\$	2,296	0.81%
Noninterest-bearing deposits	160,438				141,759			
Other liabilities	3,285				2,968			
Stockholders equity	82,545				77,858			
Total liabilities and stockholders equity	\$	823,054			\$	796,947		
Net interest income and margin (tax-equivalent)		\$	12,033	3.11%		\$	11,984	3.22%

- (1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.
- (2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.

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

	2016			2015	
	Second	First	Fourth	Third	Second
	Quarter	Quarter	Quarter	Quarter	Quarter
<i>(In thousands)</i>					
Commercial and industrial	\$ 50,190	50,192	52,479	47,925	57,310
Construction and land development	49,346	45,953	43,694	41,592	38,854
Commercial real estate	208,825	209,320	203,853	201,449	184,124
Residential real estate	113,763	117,046	116,673	117,863	115,039
Consumer installment	9,125	9,769	10,220	14,362	13,632
Total loans	431,249	432,280	426,919	423,191	408,959
Less: unearned income	(555)	(517)	(509)	(619)	(464)
Loans, net of unearned income	430,694	431,763	426,410	422,572	408,495
Less: allowance for loan losses	(4,528)	(4,774)	(4,289)	(5,127)	(4,886)
Loans, net	\$ 426,166	426,989	422,121	417,445	403,609



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

	2016			2015	
	Second	First	Fourth	Third	Second
<i>(Dollars in thousands)</i>	Quarter	Quarter	Quarter	Quarter	Quarter
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 4,774	4,289	5,127	4,886	4,722
Charge-offs:					
Commercial and industrial	(83)		(42)		
Commercial real estate	(194)		(866)		
Residential real estate	(37)	(118)	(3)	(26)	
Consumer installment	(2)	(26)	(14)	(23)	(5)
Total charge-offs	(316)	(144)	(925)	(49)	(5)
Recoveries	70	1,229	87	90	169
Net (charge-offs) recoveries	(246)	1,085	(838)	41	164
Provision for loan losses		(600)		200	
Ending balance	\$ 4,528	4,774	4,289	5,127	4,886
as a % of loans	1.05 %	1.11	1.01	1.21	1.20
as a % of nonperforming loans	271 %	246	158	140	360
Net charge-offs (recoveries) as % of avg. loans (a)	0.23 %	(1.01)	0.79	(0.04)	(0.16)
<b>Nonperforming assets:</b>					
Nonaccrual loans	\$ 1,669	1,938	2,714	3,650	1,359
Other real estate owned	300	397	252	278	499
Total nonperforming assets	\$ 1,969	2,335	2,966	3,928	1,858
as a % of loans and other real estate owned	0.46 %	0.54	0.70	0.93	0.45
as a % of total assets	0.23 %	0.28	0.36	0.48	0.23
Nonperforming loans as a % of total loans	0.39 %	0.45	0.64	0.86	0.33
Accruing loans 90 days or more past due	\$			112	442

(a) Net charge-offs (recoveries) are annualized.

**Table of Contents****Table 8 - Allocation of Allowance for Loan Losses**

<i>(Dollars in thousands)</i>	2016				2015				2015	
	Second Quarter		First Quarter		Fourth Quarter		Third Quarter		Second Quarter	
	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial and industrial	\$ 506	11.6	\$ 517	11.6	\$ 523	12.3	\$ 504	11.3	\$ 681	14.0
Construction and land development	744	11.4	695	10.6	669	10.2	627	9.8	640	9.5
Commercial real estate	2,092	48.5	2,403	48.4	1,879	47.8	2,679	47.6	2,146	45.1
Residential real estate	1,061	26.4	1,026	27.1	1,059	27.3	1,103	27.9	1,180	28.1
Consumer installment	125	2.1	133	2.3	159	2.4	214	3.4	239	3.3
Total allowance for loan losses	\$ 4,528		\$ 4,774		\$ 4,289		\$ 5,127		\$ 4,886	

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

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**Table of Contents****Table 9 - CDs and Other Time Deposits of \$100,000 or More***(Dollars in thousands)***June 30, 2016**

<b>Maturity of:</b>	
3 months or less	\$ 13,182
Over 3 months through 6 months	22,381
Over 6 months through 12 months	23,446
Over 12 months	71,549
Total CDs and other time deposits of \$100,000 or more	\$ 130,558

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

The information called for by ITEM 3 is set forth in ITEM 2 under the caption MARKET AND LIQUIDITY RISK MANAGEMENT and is incorporated herein by reference.

**ITEM 4. CONTROLS AND PROCEDURES**

The Company, with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation and as of the end of the period covered by this report, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective to allow timely decisions regarding disclosure in its reports that the Company files or submits to the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. There have been no changes in the Company's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

In the normal course of its business, the Company and the Bank are, from time to time, involved in legal proceedings. The Company's and Bank's management believe there are no pending or threatened legal, governmental, or regulatory proceedings that, upon resolution, are expected to have a material adverse effect upon the Company's or the Bank's financial condition or results of operations. See also, Part I, Item 3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. RISK FACTORS in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, which could materially affect our business, financial condition or future results. The risks described in our annual report on Form 10-K are not the only the risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, and/or operating results in the future.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

Not applicable.

**Table of Contents****ITEM 6. EXHIBITS**

Exhibit

<u>Number</u>	<u>Description</u>
3.1	Certificate of Incorporation of Auburn National Bancorporation, Inc. and all amendments thereto.*
3.2	Amended and Restated Bylaws of Auburn National Bancorporation, Inc., adopted as of November 13, 2007. **
31.1	Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.
31.2	Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Executive Vice President, Chief Financial Officer.
32.1	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.***
32.2	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Executive Vice President, Chief Financial Officer.***
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

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

\*\* Incorporated by reference from Registrant's Form 10-K dated March 31, 2008.

\*\*\* The certifications attached as exhibits 32.1 and 32.2 to this quarterly report on Form 10-Q are furnished to the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.



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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AUBURN NATIONAL BANCORPORATION, INC.  
(Registrant)

Date: July 29, 2016

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

Date: July 29, 2016

By: /s/ David A. Hedges  
David A. Hedges  
EVP, Chief Financial Officer