SIEMENS AKTIENGESELLSCHAFT
Form 6-K
November 08, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 6-K
Report of Foreign Private Issuer
Pursuant to Rule 13a-16 or 15d-16
of the Securities Exchange Act of 1934
November 8 , 2007

Commission File Number: 1-15174

Siemens Aktiengesellschaft

(Translation of registrant s name into English)

Wittelsbacherplatz 2
D-80333 Munich
Federal Republic of Germany
(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F þ Form 40-F o

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1):

Yes o No þ

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Yes o No þ

Indicate by check mark whether by furnishing the information contained in this Form, the registrant is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes o No þ

If Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-

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Press Presse Prensa
For the business and financial press
Munich, November 7, 2007

Siemens sets capital structure target and announces a share buyback program for up to 10 billion by 2010

In the framework of its Fit for 2010 program, Siemens has set a target for an optimized capital structure. It will be measured as the ratio of adjusted industrial net debt to EBITDA. The capital structure target should be in a target range between 0.8 and 1.0 by 2010. This step completes Siemens financial target system as defined in the Fit for 2010 program, while maintaining our traditionally solid financial position. At the same time, we are optimizing our capital structure on the basis of comprehensive analyses of competitors, said Siemens CFO Joe Kaeser.

In a move to achieve the target, Siemens simultaneously announced it is launching an extensive share buyback program. As a result of the strong cash flow from operations and the size of the expected proceeds from the sale of Siemens VDO, we see potential for optimizing our capital structure. We therefore foresee a share buyback program with a total volume of up to 10 billion by 2010. Ultimately, we believe that a more efficient capital structure will strengthen EPS growth while ensuring cost-effective access to capital as well as strategic flexibility, said Siemens CEO Peter Löscher.

Through resolution of the Shareholders Meeting of January 25, 2007, Siemens AG is authorized pursuant to section 71 para.1 no. 8 of the German Stock Corporation Act (Aktiengesetz, AktG) to acquire own shares up to 10% of the its capital stock until July 24, 2008. Within this authorization the Managing Board has adopted a share buy back program which has been approved by the Supervisory Board.

Accordingly this allows to acquire by purchase over the stock exchange up to a maximum of 82 million shares of Siemens AG for the purpose of cancellation and reduction of capital stock as well as to buy back up to a maximum of 7 million shares of Siemens AG to fulfill obligations arising out of stock compensation programs. On the basis of the current share price this amounts to a volume of approximately EUR 8.5 billion.

Timing and details regarding the start of the share buy back program will be announced separately. The buy back will be carried out lead-managed by banks and will be executed pursuant to the Regulation (EC) no. 2273/2003 of the Commission of December 22, 2003.

Siemens intends that the Managing Board and the Supervisory Board will propose at the Shareholders Meeting to be held on January 24, 2008 to renew the authorization to buy back shares of up to 10 % of the share capital.

On EBITDA and other definitions please visit www.siemens.com/investorrelations.

Siemens plans to publish its fiscal 2007 figures (based on IFRS) on November 8, 2007, at 7:15 a.m. (CET). The Annual Press Conference will be held on the same day in Munich, beginning at 10:00 a.m. (CET). Further information will be available in the live Webcast of the press conference at: www.siemens.com/pressekonferenz. An analyst conference will follow on November 9, 2007, in London and can also be seen as a live Webcast at: www.siemens.com/investorrelations.

Siemens AG
Corporate Communications and Government Affairs
Media Relations
80312 Munich

Reference number: AXX200711.8e
Constantin Birnstiel
80312 Munich
Tel.: +49 89 636-36669; Fax: -32825
E-Mail: constantin.birnstiel@siemens.com

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Press Presse Prensa

For the business and financial press
Munich, Germany, November 8, 2007

Siemens to raise target margin ranges for Operations

Siemens is raising the target margin ranges for its operating units. We re convinced that the creation of new structures within the three planned Sectors Energy, Industry and Healthcare will make our company less complex, more transparent, more focused and, therefore, faster and more successful. As a result, it s also clear we ll exceed the current goals of our Fit for 2010 program, said Peter Löscher, Siemens CEO. The new target margin ranges for the future Energy and Industry Sectors will be announced at the end of January 2008. Effective immediately, the target margin range for the Medical Solutions Group (Med) will be raised to 14-17% from the current 13-15%. In the course of the restructuring, Siemens also intends to reduce selling, general and administrative costs, as a percentage of sales, 10-20% by 2010.

If approved by the Supervisory Board on November 28, 2007, implementation of the new company structure will begin in January 2008. External financial reporting on the basis of the new structure will begin in the second half of fiscal 2008. Financial information will be reported at the Sector level and below. We re again making our financial reporting considerably more transparent than it is today, said Löscher.

The Energy Sector will essentially comprise the Groups Power Generation (PG) and Power Transmission and Distribution (PTD). This Sector will target a highly attractive market, which is growing at 11% a year. Siemens expects the market s total volume to be well above 300 billion by 2010.

The Industry Sector will comprise the business activities of Automation and Drives (A&D), Industrial Solutions and Services (I&S), Transportation Systems (TS), Siemens Building Technologies (SBT) and Osram. Siemens assumes that the Sector s markets will grow 5% a year to reach a total volume of nearly 500 billion by 2010.

The Healthcare Sector will comprise the Medical Solutions Group (Med). Med s latest acquisitions have more than doubled its market to 57 billion and enabled the Group to tap attractive new segments.

Siemens IT Solutions and Services and Siemens Financial Services (SFS) will continue to operate as cross-sector businesses.

The planned new structure will generate considerable synergy potentials. We re going to precisely define how staff functions are assigned to the various levels in the new structure, said Peter Löscher, with reference to the selling, general and administrative costs, which totaled some 17% of sales in fiscal 2007.

Siemens AG
Corporate Communications and Government Affairs
Media Relations
80312 München

Informationsnummer: AXX200711.12 e
Marc Langendorf
80312 München
Tel.: +49 89 636-37035; Fax: -32825
E-Mail: marc.langendorf@siemens.com

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Key figures[1][2] Fiscal 2007

Effective with the first quarter of fiscal 2007, Siemens prepares its primary financial reporting according to International Financial Reporting Standards (IFRS) on a retroactive basis.

(in millions of , except where otherwise stated)

Profit and Growth	Q4 2006	Q4 2007	*% change* *Actual*	*Adjusted*[3]	FY 2006	FY 2007	*% change* *Actual*	*Adjusted*[3]
Continuing Operations								
New Orders	17,575	21,328	21	19	74,944	83,916	12	13
Revenue	18,471	20,201	9	8	66,487	72,448	9	10
Total Operations Group								
Group Profit from Operations	749	1,990	166		3,867	6,560	70	
in % of revenue	3.8%	9.3%			5.5%	8.6%		
EBITDA adjusted	1,201	2,596	116		5,367	8,716	62	
in % of revenue	6.1%	12.1%			7.6%	11.4%		
Continuing Operations								
EBITDA adjusted	967	2,389	147		5,074	7,686	51	
Income from continuing operations	139	1,394	>200		2,642	3,909	48	
Basic earnings per share (in euros)[5]	0.10	1.45	>200		2.78	4.13	49	
Continuing and Discontinued Operations[4]								
Net Income	148	(74)			3,345	4,038	21	
Basic earnings per share (in euros)[5]	0.10	(0.17)			3.52	4.24	20	

Return on Capital Employed	Q4 2006	Q4 2007	FY 2006	FY 2007
Continuing Operations				
Return on capital employed (ROCE)	1.9%	15.5%	9.6%	12.7%
Continuing and Discontinued Operations[4]				
Return on capital employed (ROCE)	1.7%	(0.7)%	10.5%	10.9%

Free Cash Flow / Cash Conversion	Q4 2006	Q4 2007	FY 2006	FY 2007
Total Operations Groups				
Free Cash Flow	1,293	3,149	2,806	7,037
Cash Conversion	1.73	1.58	0.73	1.07
Continuing Operations				
Free Cash Flow	963	2,553	1,820	6,755
Cash Conversion	6.93	1.83	0.69	1.73
Continuing and Discontinued Operations(4)				
Free Cash Flow	1,464	2,099	1,607	3,577
Cash Conversion	9.89	> 1	0.48	0.89

Net Debt / Capital Structure	FY 2006	FY 2007
Net Debt	4,487	11,299

(1) *Preliminary and unaudited. Prior-year numbers have been adjusted for the retroactive presentation of Siemens VDO Automotive (SV) in discontinued operations, income tax charges relating to compliance matters and an adjustment of Medical Solutions Group profit.*
(2) *EBITDA adjusted, Return on capital employed, Return on equity, Free cash flow, Cash conversion, Net debt and adjusted industrial net debt are non-GAAP financial measures. A reconciliation of these amounts to the most directly comparable IFRS financial measures is available on our Investor Relations website under www.siemens.com/ir, Financial Publications, Quarterly Reports. Group profit from operations is reconciled to income before income taxes of Operations under Reconciliation to financial statements in the table Segment Information.*
(3) *Adjusted for portfolio and currency translation effects.*
(4) *Discontinued operations consist of SV activities as well as of carrier networks, enterprise networks and mobile devices activities.*
(5) *Earnings per share attributable to shareholders of Siemens AG.*
(6) *Continuing and discontinued operations.*

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Earnings Release
Munich, November 8, 2007

Strong Growth, Higher Margins

Operations delivers nearly 2 billion in Q4 Group profit

Continuing operations generate EPS of 1.45 in Q4

Siemens in the Fourth Quarter of Fiscal 2007

- **Group profit from Operations was 1.990 billion, driven up sharply year-over-year by rising profits and earnings margins at all Groups.**

- **Income from continuing operations also climbed significantly, to 1.394 billion. EPS from continuing operations was 1.45 compared to 0.10 a year earlier.**

- **Net income was a negative 74 million due to non-operating items in discontinued operations, including approximately 1.0 billion in tax expense related to the carve-out of Siemens VDO Automotive. EPS was a negative 0.17 compared to a positive 0.10 a year earlier.**

- **Siemens continued to grow more than twice as fast as global GDP. Revenue was up 9% compared to the prior-year quarter, at 20.201 billion, and orders climbed 21%, to 21.328 billion.**

- **Free cash flow rose to 2.553 billion for the quarter, on higher income from continuing operations and a substantial improvement in net working capital year-over-year.**

- **Siemens announced plans for a 10 billion share repurchase program, and proposed a dividend for fiscal 2007 of 1.60 per share compared to 1.45 per share in the prior year.**

The fourth quarter demonstrates the kind of quality growth Siemens can generate, said Siemens CEO Peter Löscher. We expanded our business in all regions of the world, and all our operating Groups reached their Fit 4 2010 target margin ranges. This success in turn produced a strong increase in free cash flow. Net income was significantly impacted by tax expense related to the carve-out of Siemens VDO Automotive.

At the corporate level, one of our plans for the year ahead is to make our balance sheet more efficient. We are therefore announcing a capital structure target ratio based on net industrial debt and EBITDA. To meet this midterm target, we are taking advantage of our strong cash position to return value to shareholders through a share buyback program, which we will conduct over the next three years up to a total of approximately 10 billion. Ultimately, we believe that a more efficient capital structure will strengthen EPS growth while ensuring cost-effective access to capital as well as strategic flexibility.

Operationally, we expect more quality growth in fiscal 2008. Specifically, we anticipate volume growth that is twice as high as the rate of global GDP growth, and that our operating profit will grow at least twice as fast as our volume. Siemens remains very well positioned in dynamic world markets for solutions in industry, energy, and healthcare.

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Income and Group Profit

Group profit from Operations climbed on higher profitability and rising revenue. With increased operating leverage from improved cost structures and successful acquisitions in recent quarters, the Groups in Operations benefited substantially from higher revenue worldwide. The result was 1.990 billion in Group profit, compared to 749 million in the fourth quarter a year earlier. All nine Groups within Operations posted significantly higher Group profit and profit margins year-over-year.

Income from continuing operations was up strongly year-over-year. Substantially higher Group profit from operations resulted in a strong increase in income from continuing operations, which climbed to 1.394 billion from 139 million in the prior-year period. Earnings per share (EPS) from continuing operations rose to 1.45 compared to 0.10 a year earlier. Financing & Real Estate and Corporate Treasury generated 119 million in income before income tax in the quarter, compared to 129 million in the prior-year period.

Net income was adversely affected by non-operating items in discontinued operations. Discontinued operations reduced net income by 1.468 billion in the fourth quarter, in large part because of the inclusion of Siemens VDO Automotive (SV) pending the close of its sale to Continental AG. Siemens recorded approximately 1.0 billion in tax expense associated with the SV carve-out. Other non-operating effects in discontinued operations include a penalty of 201 million imposed by German authorities in ending their investigation of past misconduct at the former Communications Group (Com). As a result, net income was a negative 74 million for the quarter compared to a positive 148 million in the prior-year period. Basic and diluted EPS for the current period were (0.17) and (0.19), respectively. A year earlier, both basic and diluted EPS in the fourth quarter were 0.10.

Orders and Revenue

Siemens delivered strong organic growth with excellent regional balance. With significant operations in all major regions and countries of the world, Siemens benefited strongly from favorable macroeconomic conditions in the fourth quarter. Revenue rose 9% compared to the prior-year period, to 20.201 billion, and orders climbed 21%, to 21.328 billion. On an organic basis, excluding the net effect of currency translation and portfolio transactions, revenue rose 8% year-over-year and orders climbed 19%. Growth in the Asia-Pacific region remained robust, with revenue up 19% and orders up 62%. Europe (including Germany) also had a strong quarter, with 7% growth in revenue and 26% growth in orders. The region comprised of Africa, the Near and Middle East and the Commonwealth of Independent States (C.I.S.) posted 19% revenue growth and accounted for nearly 10% of Siemens revenue in the fourth quarter. These above-mentioned regions more than made up for slower growth in the Americas, where market conditions in the U.S. changed significantly compared to the prior-year quarter. Revenue and orders in the Americas each grew 6% year-over-year despite strong adverse currency effects, partly offset by new revenue from acquisitions between the periods under review.

Cash and Return on Capital Employed (ROCE)

The cash conversion rate for the quarter was well above target. Free cash flow from continuing operations for the fourth quarter was 2.553 billion, up from 963 million in the same quarter a year earlier. This increase was driven by substantially higher income from continuing operations compared to the prior-year period, as well as higher cash inflows resulting from net working capital. The resulting cash conversion rate for the quarter was 1.83, well above the target rate of 0.92.

ROCE for fiscal 2007 was 12.7%. A year earlier, Siemens ROCE was 9.6%. ROCE development in fiscal 2008 will be affected by a substantial increase in capital employed, stemming from major acquisitions completed or announced in fiscal 2007. Siemens medium-term target for ROCE remains 14-16%.

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Legal and regulatory matters in the fourth quarter

The Munich district court imposed a fine of 201 million on Siemens, marking the end of the investigation at Com by the Munich Office of Public Prosecution insofar as it relates to Siemens AG. Siemens recorded the fine in the fourth quarter of fiscal 2007. In addition Siemens reached a final settlement with German tax authorities regarding questionable payments made under Business Consulting Agreements (BCAs), under other agreements with third-party intermediaries, and to other parties in fiscal years 2000-2006. A total of 449 million in questionable payments at Com have been determined to be non-deductible, resulting in a tax charge of 179 million. Siemens previously recorded 168 million for tax charges in its consolidated financial statements for fiscal 2006, corresponding to non-deductible payments of 417 million.

During the fourth quarter of fiscal 2007, Siemens substantially completed its analysis of the tax deductibility of questionable payments at Groups other than Com and in regional companies, also for fiscal years 2000-2006. This analysis identified in fiscal 2007 an additional 857 million in non-tax-deductible payments. Accordingly, Siemens recorded additional income tax expense of 339 million and adjusted corresponding amounts in prior periods in the consolidated financial statements for fiscal 2007. The majority of the tax total relates to payments prior to fiscal 2005, which reduces shareholders equity as of October 1, 2004. There is no impact from these tax charges on Siemens income statement for fiscal 2007.

Taking continuing operations and discontinued operations together, expenses for outside advisors engaged by Siemens in connection with investigations into alleged violations of anti-corruption laws and related matters as well as remediation activities amounted to 159 million in the fourth quarter and 347 million in fiscal 2007. More detailed information regarding compliance matters is provided in the document Legal Proceedings.

Operations in fiscal 2007

Automation and Drives (A&D): Robust Global Growth and Operating Leverage

	Fourth quarter ended September 30,				**Fiscal year ended September 30,**			
			% Change				**% Change**	
(in millions)	**2007**	**2006**	**Actual**	**Adjusted***	**2007**	**2006**	**Actual**	**Adjusted****
Group profit	607	427	42%		2,090	1,575	33%	
Group profit margin	13.8%	11.8%			13.6%	12.1%		
Revenue	4,403	3,609	22%	16%	15,389	13,041	18%	16%
New orders	4,351	3,520	24%	18%	16,794	14,312	17%	16%

* Excluding currency translation effects of (1)% on revenue and orders, and portfolio effects of 7% on revenue and orders.

** Excluding currency translation effects of (2)% on revenue and orders, and portfolio effects of 4% and 3% on revenue and orders, respectively.

A&D completed an excellent year with an outstanding fourth quarter. Group profit for the final three months jumped 42% compared to the prior-year quarter, to 607 million. The Large Drives, Mechanical Drives and Motion Control Systems divisions all demonstrated strong operating leverage with expanded revenue, resulting in significantly increased earnings. Purchase price accounting (PPA) effects associated with the Group s acquisitions of UGS Corp. (in May 2007) and Flender Holding GmbH (in fiscal 2005) sliced 63 million from Group profit, and A&D posted an additional 12 million in integration costs. These negative impacts together took 170 basis points from Group profit margin for the quarter. Revenue for A&D overall reached a new quarterly high, at 4.403 billion. Orders rose even faster, climbing 24% to 4.351 billion. A&D generated its topline growth on a worldwide basis. Revenue rose 32% in Asia-Pacific, 26% in Germany, 20% in Europe outside Germany and 16% in the Americas. These results include new volume from UGS, a leading provider of product lifecycle management (PLM) software which A&D acquired to complement and extend its existing software capabilities.

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This business got off to a good start within A&D, launching its technology integration and winning new customers for the Group.

On a full-year basis, A&D increased its Group profit 33%, to 2.090 billion. The Group gained operating leverage on rising volume, and profitability increased year-over-year even though 143 million in PPA effects and 23 million in integration costs clipped 110 basis points from Group profit margin. Revenue for fiscal 2007 climbed 18% to 15.389 billion, and orders rose 17% to 16.794 billion. Topline growth was geographically broad-based and benefited from the UGS acquisition.

Industrial Solutions and Services (I&S): ***Groupwide Increase in Profitability***

	Fourth quarter ended September 30,				Fiscal year ended September 30,			
			% Change				% Change	
(in millions)	2007	2006	Actual	Adjusted*	2007	2006	Actual	Adjusted**
Group profit	130	61	113%		415	282	47%	
Group profit margin	5.2%	2.5%			4.7%	3.2%		
Revenue	2,500	2,477	1%	2%	8,894	8,819	1%	3%
New orders	2,168	2,129	2%	3%	10,161	9,025	13%	15%

* Excluding currency translation effects of (2)% on revenue and orders, and portfolio effects of 1% on revenue and orders.

** Excluding currency translation effects of (3)% on revenue and orders, and portfolio effects of 1% on revenue and orders.

I&S closed fiscal 2007 with its strongest quarter of the year, more than doubling Group profit to 130 million. Earnings and profitability improved in all divisions compared to the prior-year quarter, most notably in the industrial services, water, and oil and gas businesses. As a result, the Group added 270 basis points to its quarterly Group profit margin. Industry-wide resource constraints and lower revenue in the postal automation business held back topline growth, as revenue rose to 2.500 billion and orders increased to 2.168 billion.

Full-year results for I&S showed similar trends, including sharply higher Group profit on restrained growth in revenue. Group profit climbed to 415 million, a 47% increase year-over-year, and both earnings and margins improved throughout the Group. Revenue for I&S overall was up 1% year-over-year, at 8.894 billion. Strong demand in the Americas and Asia-Pacific helped take orders up 13%, to 10.161 billion, for a book-to-bill ratio of 1.14 for the full fiscal year.

Siemens Building Technologies (SBT): Profiting From Higher-Margin Business

	Fourth quarter ended September 30,				Fiscal year ended September 30,			
			% Change				% Change	
(in millions)	2007	2006	Actual	Adjusted*	2007	2006	Actual	Adjusted**
Group profit	102	77	32%		354	223	59%	
Group profit margin	7.5%	5.5%			7.0%	4.6%		
Revenue	1,353	1,403	(4)%	(1)%	5,062	4,796	6%	8%
New orders	1,331	1,402	(5)%	(2)%	5,350	5,235	2%	5%

* Excluding currency translation effects of (3)% on revenue and orders.

** Excluding currency translation effects of (3)% and (4)% on revenue and orders, respectively, and portfolio effects of 1% on revenue and orders.

SBT delivered its highest quarterly Group profit of the year in the fourth quarter, at 102 million, and also added more than 200 basis points to Group profit margin compared to the prior-year period. These results demonstrate the Group s focus on reducing costs, improving execution and winning higher-margin business.

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This trend was most evident in SBT s building automation business, which more than doubled profitability compared to the same quarter a year earlier. For SBT as a whole, more selective order intake was evident in revenue of 1.353 billion, a modest decline compared to the prior-year quarter. Orders of 1.331 billion came in 5% below the fourth quarter a year ago. Key factors in this result included adverse currency translation effects and a slowdown in the U.S., which pulled U.S. orders down 15% year-over-year.

SBT s progress was even more substantial on a full-year basis, with Group profit jumping 59% year-over-year, to 354 million. Earnings and margins rose on a Groupwide basis, building a 240 basis point increase in Group profit margin. The Group s fire safety and heating, ventilation and air conditioning businesses made the largest contributions to Group Profit. Revenue rose 6% year-over-year, to 5.062 billion, and orders of 5.350 billion came in 2% higher than the prior period.

Osram: Sustained Growth and Profitability

	Fourth quarter ended September 30,				**Fiscal year ended September 30,**			
			% Change				**% Change**	
(in millions)	**2007**	**2006**	**Actual**	**Adjusted***	**2007**	**2006**	**Actual**	**Adjusted****
Group profit	128	86	49%		492	456	8%	
Group profit margin	10.6%	7.7%			10.5%	10.0%		
Revenue	1,203	1,110	8%	12%	4,690	4,563	3%	7%
New orders	1,203	1,110	8%	12%	4,690	4,563	3%	7%

* Excluding currency translation effects of (4)% on revenue and orders.

** Excluding currency translation effects of (4)% on revenue and orders.

Osram posted Group profit of 128 million in the fourth quarter of fiscal 2007, with broad-based increases in earnings and margins. Group profit in the prior year included higher severance charges. Revenue and orders rose 8% to 1.203 billion for the quarter, including high demand for energy-efficient lighting solutions.

For the full year, Osram s Group profit rose 8% to 492 million. Along with strength in general lighting, Osram also benefited from higher earnings in its optical semiconductors business. Broad-based demand throughout the Group took revenue and orders up to 4.690 billion for the fiscal year. Excluding negative currency translation effects, revenue and orders grew 7% compared to the prior year.

Transportation Systems (TS): Improved Earnings and Margins

	Fourth quarter ended September 30,				**Fiscal year ended September 30,**			
			% Change				**% Change**	
(in millions)	**2007**	**2006**	**Actual**	**Adjusted***	**2007**	**2006**	**Actual**	**Adjusted****
Group profit	62	19	226%		191	72	165%	
Group profit margin	5.1%	1.3%			4.3%	1.6%		

Revenue	1,212	1,446	(16)%	(12)%	4,452	4,493	(1)%	2%
New orders	2,189	743	195%	202%	4,780	6,173	(23)%	(20)%

* Excluding currency translation effects of (1)% on revenue and orders, and portfolio effects of (3)% and (6)% on revenue and orders, respectively.

** Excluding currency translation effects of (1)% on revenue and orders, and portfolio effects of (2)% on revenue and orders.

Group profit at TS in the fourth quarter rose to 62 million on broad-based increases in earnings and margins led by the Rail Automation division. Revenue of 1.212 billion came in below the level of the prior-year period.

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Fourth-quarter orders of 2.189 billion were nearly triple the level of the same period a year ago, driven by major contract wins in Austria, The Netherlands, the U.K., and China.

For the full year, Group profit of 191 million at TS benefited from a net gain of 76 million on the sale of the Group s locomotive leasing business. Earnings and margins rose on a Group-wide basis except for the mass transit business, which took charges related to its Combino railcar and posted a larger loss than in the prior year. Revenue of 4.452 billion came close to the prior-year level despite a decline in revenue in the mass transit business. Orders of 4.780 billion reflect a significantly lower level of large orders for the Group as a whole in the second and third quarters.

Power Generation (PG): Margin Improvement in High-Growth Markets

	Fourth quarter ended September 30,				Fiscal year ended September 30,			
			% Change				% Change	
(in millions)	2007	2006	Actual	Adjusted*	2007	2006	Actual	Adjusted**
Group profit	358	122	193%		1,147	779	47%	
Group profit margin	10.1%	4.2%			9.4%	7.7%		
Revenue	3,533	2,924	21%	21%	12,194	10,086	21%	20%
New orders	4,012	2,738	47%	46%	17,988	12,532	44%	43%

* Excluding currency translation effects of (3)% and (2)% on revenue and orders, respectively, and portfolio effects of 3% on revenue and orders.

** Excluding currency translation effects of (3)% on revenue and orders, and portfolio effects of 4% on revenue and orders.

PG combined increased profitability with strong revenue growth to generate 358 million in fourth-quarter Group profit, well above the prior-year period. PG s fossil power generation, fossil services, industrial and wind businesses all contributed significantly higher earnings year-over-year. Both periods under review included charges at major projects and negative equity investment income. With significant offsetting effects in the current quarter, Group profit margin was representative of PG s underlying performance. In contrast, Group profit margin in the prior-year quarter lost more than 500 basis points due to the factors mentioned above. Equity investment income related to Areva was a negative

37 million compared to a negative 52 million in the prior-year quarter. Demand for PG s power generation solutions was evident in revenue of 3.533 billion, 21% higher than in the prior-year quarter, and orders of 4.012 billion, up 47%. The fossil, wind and industrial businesses all contributed strong growth and major contract wins, including fuel-efficient combined-cycle power plants in Europe and Asia-Pacific and large wind power projects in Europe, Asia-Pacific and the U.S. PG expects continued volatility in equity investment earnings in coming quarters.

For the full fiscal year, Group profit at PG climbed 47%, to 1.147 billion. All businesses in PG s portfolio generated strong growth in earnings and profitability, including a significant rise in earnings in the fossil services business and a sharply higher 9.5% margin in the wind power business, where earnings more than doubled. Charges at major projects, negative equity investment income and offsetting effects took 60 net basis points from Group profit margin in fiscal 2007, compared to 230 net basis points a year earlier. Equity investment income related to Areva was a negative 45 million in fiscal 2007 compared to a negative 27 in the prior year. Demand was well-balanced both regionally and among PG s divisions. Fiscal 2007 revenue rose to 12.194 billion, 21% higher than in the prior fiscal year, and orders surged 44%, to 17.988 billion. These fiscal 2007 contract wins are expected to increase the earnings quality of PG s order backlog as older, lower-margin orders are converted to revenue in coming quarters.

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Power Transmission and Distribution (PTD): Maintaining Momentum in Growth and Profitability

	Fourth quarter ended September 30,				Fiscal year ended September 30,			
			% Change				% Change	
(in millions)	**2007**	**2006**	**Actual**	**Adjusted***	**2007**	**2006**	**Actual**	**Adjusted****
Group profit	225	54	317%		650	315	106%	
Group profit margin	9.9%	2.9%			8.5%	4.8%		
Revenue	2,283	1,839	24%	25%	7,689	6,509	18%	21%
New orders	1,882	1,683	12%	14%	9,896	8,028	23%	27%

* Excluding currency translation effects of (1)% and (2)% on revenue and orders, respectively.

** Excluding currency translation effects of (3)% and (4)% on revenue and orders, respectively.

PTD completed a year of continuous earnings improvement with Group profit of 225 million for the fourth quarter. Group profit margin benefited from 25 million in hedging effects not qualifying for hedge accounting. For comparison, the prior-year result included restructuring charges. Higher revenue enabled all divisions within PTD to increase their earnings, and the Group achieved its best quarterly Group profit margin of the year. In a strong global market for secure, high-efficiency power transmission and distribution, PTD delivered revenue of 2.283 billion, up 24% from the prior-year quarter. Orders for the quarter rose 12% above the prior-year level, to 1.882 billion, including a major order in the U.S.

PTD s full-year results follow the same trends as in the fourth quarter. Group profit more than doubled, to 650 million, on improving margins and higher revenue. Revenue rose 18% year-over-year, to 7.689 billion, while orders climbed 23%, to 9.896 billion. Among numerous major orders were large new contracts in the Middle East and China, taking PTD s full-year book-to-bill ratio up to 1.29.

Medical Solutions (Med): Strong Profit Growth From An Integrated Diagnostics Supplier

	Fourth quarter ended September 30,				Fiscal year ended September 30,			
			% Change				% Change	
(in millions)	**2007**	**2006***	**Actual**	**Adjusted****	**2007**	**2006***	**Actual**	**Adjusted*****
Group profit	380	266	43%		1,323	988	34%	
Group profit margin	13.3%	11.3%			13.4%	12.0%		
Revenue	2,848	2,359	21%	6%	9,851	8,227	20%	6%

New orders	2,999	2,994	0%	(11)%	10,271	9,334	10%	(2)%

* Group profit has been adjusted. For further information see the document Legal Proceedings.

** Excluding currency translation effects of (4)% on revenue and orders, and portfolio effects of 19% and 15% on revenue and orders, respectively.

*** Excluding currency translation effects of (5)% on revenue and orders, and portfolio effects of 19% and 17% on revenue and orders, respectively.

Group profit at Med in the fourth quarter jumped 43% compared to the prior-year quarter, to 380 million, and Group profit margin for the quarter rose to 13.3%. These results demonstrate the competitive strength and international success of Med s diagnostics imaging businesses, which increased their profitability compared to the prior-year period despite continuing market pressure in the U.S., including effects from the U.S. Deficit Reduction Act (DRA). This enabled Med to more than offset the loss of 270 basis points from Group profit margin due to PPA effects of 21 million and integration costs of 55 million stemming from two major acquisitions. The companies acquired, Diagnostic Products Corp. (late in fiscal 2006) and a division of Bayer AG (in the second quarter of fiscal 2007), have been combined into Med s new Diagnostics division for in-vitro diagnostic solutions. Revenue for the fourth quarter rose 21%, year-over-year, to 2.848 billion, including substantial new volume from the Diagnostics division.

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Orders were level at 2.999 billion, as Med compensated for the tightening in the U.S. imaging market with its Diagnostics division and growth in other regions. The Group s acquisition of Dade-Behring Holdings, Inc. closed on November 6, 2007, and will result in further integration costs in coming quarters.

Med s results for the full year showed similar development as in the fourth quarter. Group profit climbed 34%, to 1.323 billion, primarily due to higher earnings and profit margins in the diagnostics imaging businesses. Equity investment income in the current year benefited from a 23 million gain on the sale of a portion of Med s stake in a joint venture, Draeger Medical AG & Co. KG, and rose to 60 million for the year compared to 27 million a year earlier. These factors partly offset PPA effects of 91 million and integration costs from acquisitions of 84 million, which took 180 basis points from Group profit margin. Revenue of 9.851 billion and orders of 10.271 billion were up 20% and 10%, respectively, primarily as a result of the acquisitions in in-vitro diagnostics.

Siemens IT Solutions and Services (SIS): Solid Improvement

	Fourth quarter ended September 30,				**Fiscal year ended September 30,**			
			% Change				**% Change**	
(in millions)	**2007**	**2006**	**Actual**	**Adjusted***	**2007**	**2006**	**Actual**	**Adjusted****
Group profit	80	(230)			252	(731)		
Group profit margin	5.6%	(16.2)%			4.7%	(12.8)%		
Revenue	1,438	1,424	1%	2%	5,360	5,693	(6)%	5%
New orders	1,595	1,266	26%	27%	5,156	5,574	(7)%	5%

* Excluding portfolio effects of (1)% on revenue and orders.

** Excluding currency translation effects of (1)% on revenue and orders, and portfolio effects of (10)% and (11)% on revenue and orders, respectively.

SIS posted 80 million in Group profit and a Group profit margin of 5.6% in the fourth quarter, benefiting from an improved cost structure following 180 million in severance charges in the prior-year period. Revenue rose modestly compared to the prior-year quarter, to 1.438 billion. Orders jumped 26%, to 1.595 billion on strong growth in Europe. Fiscal 2007 was the first year of operation for SIS, which combines the former Siemens Business Services (SBS) Group with other strategic IT activities within Siemens. Results for SIS are stated on a retroactive basis, to provide a meaningful comparison with prior periods. Group profit for the fiscal year was 252 million, while in the prior year 576 million in severance charges contributed to a substantial loss. Revenue and orders of 5.360 billion and 5.156 billion, respectively, came in lower than the prior-year totals due to the divestment of the Group s Product Related Services (PRS) business halfway through fiscal 2006. On an organic basis, sales and orders were up 5%

year-over-year.

Strategic Equity Investments (SEI)

SEI includes results at equity from three companies in which Siemens holds a strategic equity stake: Nokia Siemens Networks B.V. (NSN), BSH Bosch und Siemens Hausgeräte GmbH (BSH), and Fujitsu Siemens Computers (Holding) B.V. (FSC). SEI posted a loss of 11 million in the fourth quarter compared to a 75 million gain in the same period a year earlier. The change year-over-year was due largely to NSN, which became part of SEI results following its formation in the third quarter. Restructuring and integration programs resulted in 86 million in charges at NSN in the fourth quarter. As a result, Siemens incurred an equity investment loss of 58 million related to NSN.

For the full year, SEI overall recorded an equity investment loss of 161 million despite a positive 268 million from BSH and FHC. In the prior year, which does not include NSN, SEI posted equity investment income of 225 million.

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In the current year, NSN took 991 million in charges including 646 million for severance. As a result, Siemens equity investment income related to NSN was a negative 429 million in fiscal 2007.

Other Operations

Other Operations consist of centrally held operating businesses not related to a Group, including Siemens Home and Office Communication Devices (SHC) and, in fiscal 2006, the distribution and industry logistics (Dematic) businesses carved out of the former Logistics and Assembly Systems Group. The result of Other Operations in the fourth quarter was a negative 71 million compared to a negative 208 million in the same period a year earlier. SHC took a small loss in the current quarter, while the prior-year quarter includes a more significant operating loss at Dematic plus a loss on the sale of the Dematic businesses. Other Operations also includes centrally carried regional costs not allocated to the Groups, totaling 45 million in the current quarter compared to 63 million in the prior-year period. Revenue for Other Operations declined to 663 million for the quarter from 1.012 billion in the prior-year period, due primarily to the divestment.

Results for fiscal 2007 followed a similar pattern. Other Operations improved to a negative 193 million compared to a negative 317 million in fiscal 2006. SHC contributed 13 million in profit for the year, while the Dematic business posted a loss of 159 million a year earlier. Centrally carried regional costs not allocated to the Groups totaled 96 million in the current period, up from 59 million in the prior year. In addition, fiscal 2007 included an impairment of 52 million at a regional payphone company in Europe. Revenue for Other Operations for the full year was 2.884 billion, down from 3.944 billion primarily due to the Dematic divestment. Within these totals, sales at SHC remained stable near 790 million.

Corporate items, pensions and eliminations

Corporate items, pension and elimination totaled a negative 451 million in the fourth quarter, compared to a negative 493 million in the prior-year quarter. This improvement was due to centrally carried pension expense, which was a positive 39 million compared to a negative 45 million in the same quarter a year earlier. Corporate items increased year-over-year to a negative 484 million compared to a negative 462 million in the prior-year period. This change includes 85 million in the current quarter for outside advisors related to legal and regulatory matters mentioned above, as well as 108 million related to Siemens regional sales organization in Germany, primarily including an impairment. For the full year, Corporate items, pensions and eliminations was a negative 1.672 billion compared to a negative 527 million in the prior year. Corporate items was the primary factor in the change year-over-year, increasing to a negative 1.728 billion from a negative 553 million in fiscal 2006. Costs related to major legal and regulatory matters totaled 843 million in the current period. Within this figure, major impacts included 440 million stemming from sanctions on major suppliers of gas-isolated switchgear, 152 million in expenses related to compliance mentioned earlier, and 81 million in funding primarily for job placement companies for former Siemens employees affected by the bankruptcy of BenQ Mobile GmbH & Co. OHG (BenQ). Corporate items also included higher expenses related to a major asset retirement obligation. Finally, the full year also includes the 108 million mentioned above for the fourth quarter. A year earlier, Corporate items benefited from a 95 million gain on the sale of an investment, as well as 70 million in positive effects from settlement of an arbitration proceeding.

Financing and Real Estate

Siemens Financial Services (SFS)

	Fourth quarter ended September 30,			Fiscal year ended September 30,		
(in millions)	2007	2006	% Change	2007	2006	% Change
Income before income taxes	52	120	(57)%	329	306	8%
Total assets				8,912	10,543	(15)%

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Income before income taxes (IBIT) at SFS was 52 million compared to 120 million in the fourth quarter a year earlier. The prior-year quarter benefited strongly from a special dividend related to an investment in the Equity division. On a full-year basis, IBIT rose to 329 million from 306 million in fiscal 2006, including gains on sales of shares in the Equity division and special dividends resulting from divestment gains by a company in which SFS holds an equity position. IBIT in the prior period included the special dividend mentioned above. Total assets declined compared to the end of fiscal 2006, due to a significant reduction in accounts receivable related to the carve-out of SV and the transfer of carrier activities into NSN.

Siemens Real Estate (SRE)

	Fourth quarter ended September 30,			Fiscal year ended September 30,		
(in millions)	2007	2006	% Change	2007	2006	% Change
Income before income taxes	48	13	269%	228	115	98%
Revenue	435	446	(2)%	1,686	1,705	(1)%
Total assets				3,091	3,221	(4)%

Income before income taxes at SRE was 48 million in the fourth quarter, which benefited from higher gains on sales of real estate. Income before income taxes for the full year was 228 million, compared to 115 million in the prior year. A year earlier, SRE s results included significantly higher vacancy charges and a lower level of real estate disposals.

Eliminations, reclassifications and Corporate Treasury

Income before income taxes from eliminations, reclassifications and Corporate Treasury was 19 million in the fourth quarter, compared to a negative 4 million in the prior-year period. The current quarter included beneficial effects at Corporate Treasury from Siemens s repurchase of outstanding notes from a 2.5 billion convertible bond issued in June 2003. On a full-year basis, IBIT from eliminations, reclassifications and Corporate Treasury was 153 million compared to a negative 18 million in fiscal 2006. The difference is due mainly to negative net effects in the prior year from a mark-to-market valuation of a cash settlement option associated with the convertible bond.

Income and earnings per share in fiscal 2007

Net income for Siemens in fiscal 2007 was 4.038 billion, a 21% increase compared to 3.345 billion in the same period a year earlier. Basic and diluted EPS were 4.24 and 4.10, respectively, compared to 3.52 and 3.51, respectively, in fiscal 2006. Net income in fiscal 2007 rose even as income from discontinued operations fell to 129 million from 703 million in fiscal 2006. More detail on discontinued operations is included below. Income from continuing operations for the year was 3.909 billion, 48% higher than 2.642 billion in fiscal 2006. Basic and diluted EPS on a continuing basis were 4.13 and 3.99, respectively, compared to 2.78 and 2.77 a year earlier.

Strong operating performance was the primary driver of higher income from continuing operations. Group profit from Operations rose 70% year-over-year to 6.560 billion, even with negative equity investment income of 429 million related to NSN. All Groups in Operations increased their Group profit and Group profit margin on a full-year basis. SIS benefited strongly from severance programs totaling 576 million in fiscal 2006, recording Group profit of 252 million for the year compared to a loss of 731 million in the prior year.

Rapid growth in Group profit more than offset a significant increase in Corporate items, pensions and eliminations year-over-year, which rose from a negative 527 in fiscal 2006 to a negative 1.672 billion in the current year. The change was due primarily to the 843 million in costs for major legal and regulatory matters mentioned above in Corporate items.

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Earnings at Financing and Real Estate rose to 557 million for fiscal 2007, from 421 million a year earlier. Corporate Treasury activities contributed earnings of 153 million compared to a loss of 18 million in the same period a year earlier, which includes a 143 million net negative effect related to a cash settlement option related to the 2.5 billion convertible bond.

Discontinued Operations in the fourth quarter and fiscal 2007

Discontinued operations include Com activities that remained within Siemens after the transfer of carrier assets into NSN at the beginning of the third quarter, and also the operations of SV, which is held for disposal pending the closing of its sale to Continental. SV is included within discontinued operations on a retroactive basis, to provide a meaningful comparison with prior periods.

In the fourth quarter, discontinued operations reduced net income by 1.468 billion compared to a contribution to net income of 9 million in the same quarter a year earlier. The difference is due primarily to SV, which had approximately 1.0 billion in tax expense related to its carve-out. This led to a negative result of 861 million at SV activities for the quarter despite Group profit of 143 million. The prior-year result was a 77 million contribution to net income from SV activities. The result for Com activities was a negative 588 million compared to a negative 25 million in the prior-year period. The difference is due mainly to non-operating factors in the current quarter. The largest of these is the 201 million fine imposed by German authorities as discussed earlier. In addition, a non-cash, pretax, preliminary gain of approximately 1.7 billion generated by the transfer of Com assets into NSN was adjusted to approximately 1.6 billion in the fourth quarter, and the enterprise network business within discontinued operations took an impairment of 64 million. On an operating basis, Com activities posted losses of 115 million in the current quarter and 113 million in the prior-year period, which included 235 million in severance charges.

For fiscal 2007, income from discontinued operations contributed 129 million to net income, compared to 703 million a year earlier. Contribution to net income from SV activities was a negative 550 million compared to a positive 410 million in fiscal 2006. This swing was due to the approximately 1.0 billion in tax expense mentioned above as well as interest expense and closing costs related to the carve-out. Full-year results at Com-related activities contributed positively in both the current and prior year, with 765 million and 357 million, respectively. The current-year result was higher primarily due to the 1.6 billion NSN gain mentioned above. This gain was partly offset by 567 million in impairments at the enterprise networking business, the 201 million penalty mentioned above, and 104 million in other costs related to legal and regulatory matters. The remainder of the change year-over-year is due to an operating loss in the current year compared to operating profit at Com a year earlier. While the profitable carrier activities were included for all of fiscal 2006, they were transferred out of discontinued operations and into NSN midway through fiscal 2007. Effects related to BenQ reduced net income by 86 million and 64 million, respectively, in fiscal 2007 and fiscal 2006.

Order and revenue trends in fiscal 2007

	New Orders (location of customer)					
			% Change vs. previous year		*therein*	
(in millions)	**2007**	**2006**	**Actual**	**Adjusted***	*Currency*	*Portfolio*
Germany	13,562	12,782	6%	5%	*0%*	*1%*
Europe (other than Germany)	26,648	22,351	19%	18%	*0%*	*1%*
Americas	22,831	20,202	13%	18%	*(9)%*	*4%*
Asia-Pacific	13,291	11,250	18%	19%	*(3)%*	*2%*
Africa, Near and Middle East, C.I.S.**	7,584	8,359	(9)%	(7)%	*(3)%*	*1%*
Siemens	**83,916**	**74,944**	**12%**	**13%**	***(3)%***	***2%***

*

Excluding currency translation and portfolio effects.

** Commonwealth of Independent States.

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Siemens booked 83.916 billion in new orders in fiscal 2007. This 12% rise compared to fiscal 2006 resulted in a book-to-bill ratio of 1.16 for the year. Europe outside Germany and the Americas were the two largest regions by volume, followed by Germany and Asia Pacific. Europe outside Germany showed the fastest growth of any region, with a 19% increase to 26.648 billion for the year led by strong demand at PG, Med, PTD and A&D and numerous large new contracts. Orders in Germany were 13.562 billion, up 6% including strong contributions from A&D, PG and TS.

In the Americas region, orders rose 13% compared to fiscal 2006, to 22.831 million, despite considerable weakening of the U.S. dollar against the euro during the year. Continuing demand for energy solutions at PG, and for industrial automation solutions at A&D and I&S, more than compensated for industry, market and currency conditions that led to reported reductions in orders in the U.S. at Med, Osram and SBT. As a result, the U.S. share of orders in the region fell to 73% compared to 78% in fiscal 2006. On an organic basis, excluding the net effect of portfolio transactions and unusually strongly negative currency translation effects, orders were up 18% in the Americas overall.

Orders in Asia-Pacific came in at 13.291 billion, 18% higher than in the prior year, with PG, A&D, PTD, Med and I&S all winning at least 20% more new business in the region compared to fiscal 2006. Orders in China and India grew at 12% and 15% respectively, and accounted for 52% of new Asia-Pacific orders during fiscal 2007. A year earlier, their combined share was 54%. New orders in the Africa, Near and Middle East, C.I.S. region came in 9% lower year-over-year, at 7.584 billion, primarily because the prior year included a very large order at TS for both trains and maintenance in Russia. For the region as a whole, PTD, A&D and Osram saw double-digit order growth for the current period.

				&nbsamily:Times New Roman" SIZE="2">	182	1	$ 50,904		
Agency RMBS (a)			14,935		149,863	164,798	2,534	129	162,393
State and political subdivisions		414	17,761		63,538	81,713	4,339	48	77,422
Trust preferred securities:									
Pooled					100	100		130	230
Individual issuers					1,886	1,886	186	243	1,943
Total available-for-sale	$	414	37,709		261,459	299,582	7,241	551	$ 292,892

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

Securities with aggregate fair values of $150.9 million and $161.5 million at March 31, 2012 and December 31, 2011, 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 amount of cost-method investments was $5.0 million at both March 31, 2012 and December 31, 2011, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (FRB) stock.

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Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at March 31, 2012 and December 31, 2011, respectively, 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	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2012:						
Agency obligations	$ 14,884	89			$ 14,884	89
Agency RMBS	37,566	134			37,566	134
State and political subdivisions	3,349	84	288	12	3,637	96
Trust preferred securities:						
Individual issuer			780	220	780	220
Total	$ 55,799	307	1,068	232	$ 56,867	539
December 31, 2011:						
Agency obligations	$ 5,000	1			$ 5,000	1
Agency RMBS	17,020	129			17,020	129
State and political subdivisions	1,686	11	718	37	2,404	48
Trust preferred securities:						
Pooled			100	130	100	130
Individual issuer			757	243	757	243
Total	$ 23,706	141	1,575	410	$ 25,281	551

The applicable date for determining when securities are in an unrealized loss position is March 31, 2012. As such, it is possible that a security in an unrealized loss position at March 31, 2012 had a market value that exceeded its amortized cost on other days during the past twelve-month period.

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

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

the length of time and the extent to which the fair value has been less than the amortized cost basis;

adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);

the historical and implied volatility of the fair value of the security;

the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;

failure of the issuer of the security to make scheduled interest or principal payments;

any changes to the rating of the security by a rating agency; and

recoveries or additional declines in fair value subsequent to the balance sheet date.

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Agency obligations

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

Agency residential mortgage-backed securities (RMBS)

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

Securities of U.S. states and political subdivisions

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

Individual issuer s trust preferred securities

The unrealized losses associated with individual issuer trust preferred securities were related to securities backed by individual issuer community banks. For individual issuers, management evaluates the financial performance of the issuer on a quarterly basis to determine if it is probable that the issuer can make all contractual principal and interest payments. Based upon its evaluation, the Company expects to recover the remaining amortized cost basis of these securities.

Cost-method investments

At March 31, 2012, cost-method investments with an aggregate cost of $5.0 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 individual issuers of trust preferred securities, or the credit quality of other securities deteriorate and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that significant other-than-temporary impairment charges may occur in the future.

The following tables show the applicable credit ratings, fair values, gross unrealized losses, and life-to-date impairment charges for pooled and individual issuer trust preferred securities at March 31, 2012 and December 31, 2011, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer.

Trust Preferred Securities as of March 31, 2012

	Credit Rating		Fair	Unrealized Losses			Life-to-date
(Dollars in thousands)	**Moody s**	**Fitch**	**Value**	**Less than 12 months**	**12 months or Longer**	**Total**	**Impairment Charges**
Individual issuers (a):							
Carolina Financial Capital Trust I	n/a	n/a	$ 246				257
Main Street Bank Statutory Trust I (b)	n/a	n/a	393		107	107	
TCB Trust	n/a	n/a	387		113	113	
Total trust preferred securities			$ 1,026		220	220	257

n/a - not applicable, securities not rated.

(a) 144A Floating Rate Capital Securities. Underlying issuer is a community bank holding company. Securities have no excess subordination or overcollateralization.

(b) Now an obligation of BB&T Corporation.

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Trust Preferred Securities as of December 31, 2011

(Dollars in thousands)	Credit Rating Moody s	Fitch		Fair Value	Unrealized Losses Less than 12 months	12 months or Longer	Total	Life-to-date Impairment Charges
Pooled:								
ALESCO Preferred Funding XVII Ltd (a)	C	CC	$	100		130	130	1,770
Individual issuers (b):								
Carolina Financial Capital Trust I	n/a	n/a		193				257
Main Street Bank Statutory Trust I (c)	n/a	n/a		389		111	111	
MNB Capital Trust I	n/a	n/a		55				445
PrimeSouth Capital Trust I	n/a	n/a		75				425
TCB Trust	n/a	n/a		368		91	91	
United Community Capital Trust	n/a	n/a		806				379
Total individual issuer				1,886		202	202	1,506
Total trust preferred securities			$	1,986		332	332	3,276

n/a - not applicable securities not rated.

(a) Class B Deferrable Third Priority Secured Floating Rate Notes. The underlying collateral is primarily composed of trust preferred securities issued by community banks and thrifts.

(b) 144A Floating Rate Capital Securities. Underlying issuer is a community bank holding company. Securities have no excess subordination or overcollateralization.

(c) Now an obligation of BB&T Corporation.

Other-Than-Temporarily Impaired Securities

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and the credit component of the loss is recognized in earnings (referred to as credit-impaired debt securities). Other-than-temporary impairments recognized in earnings for the quarters ended March 31, 2012 and 2011, for credit-impaired debt securities are presented as additions in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). The credit loss component is reduced if the Company sells, intends to sell, or believes it will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if the Company receives cash flows in excess of what it expected to receive over the remaining life of the credit-impaired debt security, the security matures or the security is fully written-down and deemed worthless. Changes in the credit loss component of credit-impaired debt securities were:

(Dollars in thousands)	Quarter ended March 31, 2012	2011
Balance, beginning of period	$ 3,276	$ 2,938
Additions:		
Subsequent credit impairments	130	51
Reductions:		

Securities sold	2,149	
Balance, end of period	$ 1,257	$ 2,989

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Other-Than-Temporary Impairment

The following table presents details of the other-than-temporary impairment related to securities, including equity securities carried at cost, for the quarter ended March 31, 2012 and 2011.

(Dollars in thousands)	Quarter ended March 31, 2012	2011
Other-than-temporary impairment charges (included in earnings):		
Debt securities:		
Individual issuer trust preferred securities	$ 130	$ 51
Total debt securities	130	51
Total other-than-temporary impairment charges (included in earnings)	$ 130	$ 51
Other-than-temporary impairment on debt securities:		
Recorded as part of gross realized losses:		
Credit-related	$ 130	$ 51
Recorded directly to other comprehensive income for non-credit related impairment		210
Total other-than-temporary impairment on debt securities	$ 130	$ 261

Realized Gains and Losses

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

(Dollars in thousands)	Quarter ended March 31, 2012	2011
Gross realized gains	$ 473	$ 28
Gross realized losses	(164)	(23)
Other-than-temporary impairment charges	(130)	(51)
Realized gains (losses), net	$ 179	$ (46)

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NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES

(In thousands)	0000000000000 March 31, 2012	0000000000000 December 31, 2011
Commercial and industrial	$ 56,804	$ 54,988
Construction and land development	34,350	39,814
Commercial real estate:		
Owner occupied	74,444	70,202
Other	98,821	92,233
Total commercial real estate	173,265	162,435
Residential real estate:		
Consumer mortgage	60,497	57,958
Investment property	44,686	43,767
Total residential real estate	105,183	101,725
Consumer installment	10,953	11,454
Total loans	380,555	370,416
Less: unearned income	(178)	(153)
Loans, net of unearned income	$ 380,377	$ 370,263

Loans secured by real estate were approximately 82.2% of the total loan portfolio at March 31, 2012. Due to declines in economic indicators and real estate values, loans secured by real estate may have a greater risk of non-collection than other loans. At March 31, 2012, 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 lines for construction of residential, multi-family and commercial buildings. Generally the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

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

Owner occupied includes loans secured by business facilities to finance business operations, equipment and owner-occupied facilities primarily for small and medium-sized commercial customers. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower, who owns the property.

Other primarily includes loans to finance income-producing commercial and multi-family properties. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, warehouses and apartments leased generally to local businesses and residents. Generally the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates as well as the financial health of the borrower.

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

Consumer mortgage primarily includes first or second lien mortgages and home equity lines to consumers that are secured by a primary residence or second home. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history and property value.

Investment property primarily includes loans to finance income-producing 1-4 family residential properties. Generally the primary source of repayment is dependent upon income generated from leasing the property securing the loan. The underwriting of these loans takes into consideration the rental rates as well as the financial health of the borrower.

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

The following is a summary of current, accruing past due and nonaccrual loans by portfolio class as of March 31, 2012, and December 31, 2011.

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
March 31, 2012:						
Commercial and industrial	$ 56,341	174	209	56,724	80	$ 56,804
Construction and land development	29,846			29,846	4,504	34,350
Commercial real estate:						
Owner occupied	72,542	258		72,800	1,644	74,444
Other	97,103			97,103	1,718	98,821
Total commercial real estate	169,645	258		169,903	3,362	173,265
Residential real estate:						
Consumer mortgage	59,108	262	22	59,392	1,105	60,497
Investment property	43,120	395		43,515	1,171	44,686
Total residential real estate	102,228	657	22	102,907	2,276	105,183
Consumer installment	10,846	99		10,945	8	10,953
Total	$ 368,906	1,188	231	370,325	10,230	$ 380,555
December 31, 2011:						
Commercial and industrial	$ 53,721	1,191		54,912	76	$ 54,988
Construction and land development	34,402	317		34,719	5,095	39,814
Commercial real estate:						
Owner occupied	68,551			68,551	1,651	70,202
Other	90,427			90,427	1,806	92,233
Total commercial real estate	158,978			158,978	3,457	162,435
Residential real estate:						
Consumer mortgage	56,610	400		57,010	948	57,958
Investment property	42,144	845		42,989	778	43,767
Total residential real estate	98,754	1,245		99,999	1,726	101,725
Consumer installment	11,397	57		11,454		11,454
Total	$ 357,252	2,810		360,062	10,354	$ 370,416

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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. Loan losses are charged off 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. Allocation of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management s judgment, is deemed to be uncollectible.

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

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

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

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

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

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At March 31, 2012 and December 31, 2011, and for the periods then ended, the Company adjusted its historical loss rates for one segment, the commercial real estate portfolio segment, based in part, on loss rates of peer bank groups.

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

The Company periodically re-evaluates its practices in determining the allowance for loan losses. During the fourth quarter of 2011, the Company s management decided to eliminate a previously unallocated component of the allowance.

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As a result, the Company had no unallocated amount included in the allowance at March 31, 2012 and December 31, 2011, respectively.

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

	0000000000	0000000000	0000000000	0000000000	0000000000	0000000000	0000000000 March 31, 2012
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Unallocated**	**Total**
Quarter ended:							
Beginning balance	$ 948	1,470	3,009	1,363	129		$ 6,919
Charge-offs				(33)	(7)		(40)
Recoveries	3			6	8		17
Net (charge-offs) recoveries	3			(27)	1		(23)
Provision	(106)	(31)	807	(4)	(66)		600
Ending balance	$ 845	1,439	3,816	1,332	64		$ 7,496

							March 31, 2011
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Unallocated**	**Total**
Quarter ended:							
Beginning balance	$ 972	2,223	2,893	1,336	141	111	$ 7,676
Charge-offs	(56)	(33)	(339)	(57)	(1)		(486)
Recoveries	11	1		49	4		65
Net (charge-offs) recoveries	(45)	(32)	(339)	(8)	3		(421)
Provision	215	66	143	(44)	58	162	600
Ending balance	$ 1,142	2,257	2,697	1,284	202	273	$ 7,855

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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 March 31, 2012 and December 31, 2011.

		000000000000	000000000000	000000000000	000000000000	000000000000	000000000000
		Collectively evaluated (1)		Individually evaluated (2)		Total	
(In thousands)		Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
March 31, 2012:							
Commercial and industrial	$	845	56,598		206	845	56,804
Construction and land development		1,118	29,960	321	4,390	1,439	34,350
Commercial real estate		2,509	169,051	1,307	4,214	3,816	173,265
Residential real estate		996	103,596	336	1,587	1,332	105,183
Consumer installment		64	10,953			64	10,953
Total	$	5,532	370,158	1,964	10,397	7,496	380,555
December 31, 2011:							
Commercial and industrial	$	948	54,772		216	948	54,988
Construction and land development		1,323	34,719	147	5,095	1,470	39,814
Commercial real estate		2,201	158,053	808	4,382	3,009	162,435
Residential real estate		1,097	100,432	266	1,293	1,363	101,725
Consumer installment		129	11,454			129	11,454
Total	$	5,698	359,430	1,221	10,986	6,919	370,416

(1) Represents loans collectively evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies* (formerly FAS 5), and pursuant to amendments by ASU 2010-20 regarding allowance for unimpaired loans.
(2) Represents loans individually evaluated for impairment in accordance with ASC 310-30, *Receivables* (formerly FAS 114), and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

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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 current economic conditions and are defined as follows:

Pass loans which are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral.

Special Mention loans with potential weakness that may, if not reversed or corrected, weaken the credit or inadequately protect the Company s position at some future date. These loans are not adversely classified and do not expose an institution to sufficient risk to warrant an adverse classification.

Substandard Accruing loans that exhibit a well-defined weakness which presently jeopardizes debt repayment, even though they are currently performing. These loans are characterized by the distinct possibility that the Company may incur a loss in the future if these weaknesses are not corrected;

Nonaccrual includes loans where management has determined that full payment of principal and interest is in doubt.

					March 31, 2012
(In thousands)	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
Commercial and industrial	$ 55,694	242	788	80	$ 56,804
Construction and land development	28,446	405	995	4,504	34,350
Commercial real estate:					
Owner occupied	66,836	4,910	1,054	1,644	74,444
Other	88,283	617	8,203	1,718	98,821
Total commercial real estate	155,119	5,527	9,257	3,362	173,265
Residential real estate:					
Consumer mortgage	52,684	1,881	4,827	1,105	60,497
Investment property	39,768	1,561	2,186	1,171	44,686
Total residential real estate	92,452	3,442	7,013	2,276	105,183
Consumer installment	10,589	221	135	8	10,953
Total	$ 342,300	9,837	18,188	10,230	$ 380,555

					December 31, 2011
(In thousands)	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
Commercial and industrial	$ 52,834	1,359	719	76	$ 54,988
Construction and land development	33,373	266	1,080	5,095	39,814
Commercial real estate:					
Owner occupied	62,543	4,951	1,057	1,651	70,202
Other	81,584	622	8,221	1,806	92,233
Total commercial real estate	144,127	5,573	9,278	3,457	162,435
Residential real estate:					
Consumer mortgage	50,156	1,575	5,279	948	57,958
Investment property	38,732	2,225	2,032	778	43,767
Total residential real estate	88,888	3,800	7,311	1,726	101,725

Consumer installment		11,078	248	128		11,454
Total	$	330,300	11,246	18,516	10,354	$ 370,416

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Impaired loans

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

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

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

The following tables set forth certain information regarding the Company s impaired loans that were individually evaluated for impairment at March 31, 2012 and December 31, 2011.

000000000000	000000000000	000000000000	000000000000	000000000000
	March 31, 2012			
(In thousands)	**Unpaid principal balance (1)**	**Charge-offs and payments applied (2)**	**Recorded investment (3)**	**Related allowance**
With no allowance recorded:				
Commercial and industrial	$ 206		206	
Construction and land development	2,879	(1,572)	1,307	
Commercial real estate:				
Owner occupied	361	(11)	350	
Other	510	(53)	457	
Total commercial real estate	871	(64)	807	
Residential real estate:				
Consumer mortgages				
Investment property				
Total residential real estate				
Consumer installment				
Total	$ 3,956	(1,636)	2,320	
With allowance recorded:				
Commercial and industrial	$			$
Construction and land development	3,288	(205)	3,083	321
Commercial real estate:				
Owner occupied	2,252	(36)	2,216	761
Other	1,242	(51)	1,191	546
Total commercial real estate	3,494	(87)	3,407	1,307
Residential real estate:				
Consumer mortgages	992	(106)	886	80
Investment property	715	(14)	701	256
Total residential real estate	1,707	(120)	1,587	336
Consumer installment				

Total	$	8,489	(412)	8,077	$	1,964
Total impaired loans	$	12,445	(2,048)	10,397	$	1,964

(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.

(In thousands)	December 31, 2011 Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
With no allowance recorded:				
Commercial and industrial	$ 216		216	
Construction and land development	3,958	(1,572)	2,386	
Commercial real estate:				
Owner occupied	361	(11)	350	
Other	655	(50)	605	
Total commercial real estate	1,016	(61)	955	
Residential real estate:				
Consumer mortgages				
Investment property				
Total residential real estate				
Consumer installment				
Total	$ 5,190	(1,633)	3,557	
With allowance recorded:				
Commercial and industrial	$			$
Construction and land development	2,882	(173)	2,709	147
Commercial real estate:				
Owner occupied	2,255	(29)	2,226	544
Other	1,242	(41)	1,201	264
Total commercial real estate	3,497	(70)	3,427	808
Residential real estate:				
Consumer mortgages	1,707	(797)	910	103
Investment property	390	(7)	383	163
Total residential real estate	2,097	(804)	1,293	266
Consumer installment				
Total	$ 8,476	(1,047)	7,429	$ 1,221
Total impaired loans	$ 13,666	(2,680)	10,986	$ 1,221

(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.

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 period.

(In thousands)	Quarter ended March 31, 2012 Average recorded investment	Quarter ended March 31, 2012 Total interest income recognized	Quarter ended March 31, 2011 Average recorded investment	Quarter ended March 31, 2011 Total interest income recognized
Impaired loans:				
Commercial and industrial	$ 211	$ 4	$ 514	$
Construction and land development	4,902		4,072	
Commercial real estate:				
Owner occupied	2,570	17	3,010	3
Other	1,691		1,524	
Total commercial real estate	4,261	17	4,534	3
Residential real estate:				
Consumer mortgages	894		1,943	
Investment property	463		89	
Total residential real estate	1,357		2,032	
Consumer installment				
Total	$ 10,731	$ 21	$ 11,152	$ 3

Troubled Debt Restructurings

Impaired loans also include troubled debt restructurings (TDRs). In the normal course of business, management grants concessions to borrowers, which would not otherwise be considered where the borrowers are experiencing financial difficulty. A concession may include, but is not limited to, 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. The Company s determination of whether a loan modification is a TDR 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.

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

At March 31, 2012 and December 31, 2011, the Company had impaired loans classified as TDRs of $8.3 million and $9.6 million, respectively. The Company had $1.1 million in accruing TDRs at both March 31, 2012 and December 31, 2011**.** For impaired loans classified as TDRs, the related allowance for loan losses was approximately $1.4 million and $1.0 million at March 31, 2012 and December 31, 2011, respectively. At March 31, 2012, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

Effective July 1, 2011, the Company adopted ASU 2011-02, *A Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring*. As such, the Company reassessed all restructurings that occurred on or after January 1, 2011 for identification and disclosure as TDRs.

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The following table summarizes the recorded investment in loans modified in a TDR both before and after their modification during the quarter ended March 31, 2012 and 2011.

	Quarter ended March 31, 2012			Quarter ended March 31, 2011		
(Dollars in thousands)	Number of contracts	Pre-modification outstanding recorded investment	Post - modification outstanding recorded investment	Number of contracts	Pre-modification outstanding recorded investment	Post - modification outstanding recorded investment
TDRs:						
Commercial and industrial		$			$	
Construction and land development	2	2,842	1,753			
Commercial real estate:						
Owner occupied	1	818	818	2	1,098	811
Other	2	1,804	1,657			
Total commercial real estate	3	2,622	2,475	2	1,098	811
Residential real estate:						
Consumer mortgages						
Investment property						
Total residential real estate						
Consumer installment						
Total	5	$ 5,464	4,228	2	$ 1,098	811

The majority of the loans modified in a TDR during the quarter ended March 31, 2012 and 2011, respectively, included delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was not considered to be a market rate. For the quarter ended March 31, 2012, decreases in the post modification outstanding recorded investment were due to principal payments made by borrowers at the date of modification. For the quarter ended March 31, 2011, one of the modifications was an A/B note restructuring, where the B note was charged off. Total charge-offs related to B notes during the quarter ended March 31, 2011 were approximately $0.3 million.

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 quarter ended March 31, 2012 and 2011.

	Quarter ended March 31, 2012		Quarter ended March 31, 2011	
(Dollars in thousands)	Number of Contracts	Recorded investment(1)	Number of Contracts	Recorded investment(1)
TDRs:				
Commercial and industrial		$		$
Construction and land development	1	2,386		
Commercial real estate:				
Owner occupied				
Other				
Total commercial real estate				
Residential real estate:				
Consumer mortgages			1	204
Investment property				

Total residential real estate				1		204
Consumer installment						
Total	1	$	2,386	1	$	204

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

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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 Company s MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income.

The 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 change in amortized MSRs and the related valuation allowance for the quarter ended March 31, 2012 and 2011 are presented below.

	Quarter ended March 31,	
(Dollars in thousands)	**2012**	**2011**
Beginning balance	$ 1,245	1,189
Additions, net	169	87
Amortization expense	(91)	(50)
Change in valuation allowance	(63)	
Ending balance	$ 1,260	1,226
Fair value of amortized MSRs:		
Beginning of period	1,245	1,335
End of period	$ 1,260	1,491

The Company periodically evaluates mortgage servicing rights for impairment. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation reserve is established. At March 31, 2012 and December 31, 2011, the carrying value of MSRs, net included a valuation allowance of $180,000 and $117,000, respectively.

NOTE 7: DERIVATIVE INSTRUMENTS

Financial derivatives are reported at fair value in other assets or other liabilities. 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. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these swaps, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At March 31, 2012, the Company had no derivative contracts to assist in managing its interest rate sensitivity.

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

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A summary of the Company s interest rate swaps as of and for the quarter ended March 31, 2012 is presented below.

(Dollars in thousands)	Notional	Other Assets Estimated Fair Value	Other Liabilities Estimated Fair Value	Other noninterest income Gains (Losses)
Interest rate swap agreements:				
Pay fixed / receive variable	$ 5,269		1,250	$ 149
Pay variable / receive fixed	5,269	1,250		(149)
Total interest rate swap agreements	$ 10,538	1,250	1,250	$

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 quarter ended March 31, 2012, there were no transfers between levels and no changes in valuation techniques for the Company s financial assets and liabilities.

Assets and liabilities measured at fair value on a recurring basis

Securities available-for-sale

Fair values of securities available for sale were primarily measured using Level 2 inputs. For these securities, the Company obtains pricing from third party pricing services. These third party pricing services consider observable data that may include broker/dealer quotes, market spreads, cash flows, market consensus prepayment speeds, benchmark yields, reported trades, 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.

Fair values of individual issuer trust preferred securities were measured using Level 3 inputs. Because there is no active market for these securities, the Company engages a third party firm who specializes in valuing illiquid securities. The third party firm utilizes a discount cash flow model to estimate the fair value measurements for these securities. The

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credit spread that is included in the discount rate applied to the projected future cash flows is an unobservable input that is significant to the overall fair value measurement for these securities. Significant increases (decreases) in the credit spread could result in a lower (higher) fair value measurement. Because these trust preferred securities were issued by individual community banks, the credit spread will generally increase when the financial performance of the issuer deteriorates and decrease as the financial performance of the issuer improves.

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 market participants may be utilized to corroborate the fair value measurements for our interest rate swap agreements. The Company classified these derivative assets and liabilities within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments.

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of March 31, 2012 and December 31, 2011, respectively, by caption, on the Condensed Consolidated Balance Sheets by FASB ASC 820 valuation hierarchy (as described above).

(Dollars in thousands)	**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
March 31, 2012:				
Securities available-for-sale:				
Agency obligations	$ 40,817		40,817	
Agency RMBS	173,459		173,459	
State and political subdivisions	84,600		84,600	
Trust preferred securities:				
Individual issuer	1,026			1,026
Total securities available-for-sale	299,902		298,876	1,026
Other assets [(1)]	1,250		1,250	
Total assets at fair value	$ 301,152		300,126	1,026
Other liabilities[(1)]	1,250		1,250	
Total liabilities at fair value	$ 1,250		1,250	
December 31, 2011:				
Securities available-for-sale:				
Agency obligations	$ 51,085		51,085	
Agency RMBS	164,798		164,798	
State and political subdivisions	81,713		81,713	
Trust preferred securities:				
Pooled	100			100
Individual issuer	1,886			1,886
Total securities available-for-sale	299,582		297,596	1,986
Other assets [(1)]	1,325		1,325	
Total assets at fair value	$ 300,907		298,921	1,986
Other liabilities[(1)]	1,325		1,325	

Total liabilities at fair value	$	1,325	1,325

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

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

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

Mortgage servicing rights, net

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

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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 March 31, 2012 and December 31, 2011, respectively, by caption, on the Condensed Consolidated Balance Sheets and by FASB ASC 820 valuation hierarchy (as described above):

(Dollars in thousands)		**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
March 31, 2012:					
Loans held for sale	$	1,399		1,399	
Loans, net[1]		8,433			8,433
Other real estate owned		7,346			7,346
Other assets [2]		1,260			1,260
Total assets at fair value	$	18,438		1,399	17,039
December 31, 2011:					
Loans held for sale	$	3,346		3,346	
Loans, net[1]		9,765			9,765
Other real estate owned		7,898			7,898
Other assets [2]		1,245			1,245
Total assets at fair value	$	22,254		3,346	18,908

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

[2] Represents the carrying value of MSRs, net.

Quantitative Disclosures for Level 3 Fair Value Measurements

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements for trust preferred securities recognized in the accompanying Condensed Consolidated Balance Sheets using Level 3 inputs:

	Quarter ended March 31			
(Dollars in thousands)		**2012**		**2011**
Beginning balance	$	1,986	$	2,149
Total realized and unrealized gains and (losses):				
Included in net earnings		(6)		(51)
Included in other comprehensive income		20		135
Sales		(974)		
Ending balance	$	1,026	$	2,233

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For Level 3 assets measured at fair value on a recurring or non-recurring basis as of March 31, 2012, the significant unobservable inputs used in the fair value measurements are presented below.

(Dollars in thousands)	Carrying Amount	Valuation Technique	Significant Unobservable Input	Weighted Average of Input
Recurring:				
Trust preferred securities	$ 1,026	Discounted cash flow	Credit spread (basis points)	627 bp
Nonrecurring:				
Impaired loans	$ 8,433	Appraisal	Appraisal discounts (%)	22.5 %
Other real estate owned	7,346	Appraisal	Appraisal discounts (%)	10.9 %
Mortgage servicing rights, net	1,260	Discounted cash flow	Prepayment speed or CPR (%)	19.1 %
			Discount rate (%)	11.0 %

Fair Value of Financial Instruments

FASB 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 a good faith estimate of the fair value of financial instruments held by the Company. FASB ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

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

Loans, net

Fair values for loans were calculated using discounted cash flows. The discount rates reflected current rates at which similar loans would be made for the same remaining maturities. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by FASB 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.

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.

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The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company s financial instruments at March 31, 2012 and December 31, 2011 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 deposits with no stated maturity, which are payable on demand at the reporting date (i.e, their carrying amount) and short-term borrowings.

						Fair Value Hierarchy			
(Dollars in thousands)		**Carrying amount**		**Estimated fair value**		**Level 1 inputs**		**Level 2 inputs**		**Level 3 Inputs**
March 31, 2012:										
Financial Assets:										
Loans, net (1)	$	372,881	$	381,115	$		$		$	381,115
Financial Liabilities:										
Time Deposits	$	272,680	$	277,486	$		$	277,486	$	
Long-term debt		47,308		51,142				51,142		
December 31, 2011:										
Financial Assets:										
Loans, net (1)	$	363,344	$	371,433	$		$		$	371,433
Financial Liabilities:										
Time Deposits	$	281,362	$	286,644	$		$	286,644	$	
Long-term debt		85,313		93,360				93,360		

(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

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 the 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 ended March 31, 2012 and 2011, as well as the information contained in our annual report on Form 10-K for the year ended December 31, 2011.

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 our actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as may, will, anticipate, assume, should, desired, indicate, would, be contemplate, expect, seek, estimate, evaluate, continue, plan, point to, project, predict, could, intend, target, poter 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, and changes in the scope and cost of FDIC insurance and other coverage;

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 reserves for possible loan losses and other estimates, including estimates of potential losses due to claims from purchases of mortgages that we originated;

the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions;

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

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

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

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

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, 2011 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, Valley, Hurtsboro and Notasulga, Alabama. In-store branches are located in the Auburn and Opelika Kroger stores, as well as Wal-Mart SuperCenter stores in Auburn, Opelika and Phenix City, Alabama. Loan production offices are located in Montgomery, and Phenix City, Alabama.

Summary of Results of Operations

	Quarter ended March 31,			
(Dollars in thousands, except per share amounts)	**2012**		**2011**	
Net interest income (a)	$	5,415	$	5,249
Less: tax-equivalent adjustment		414		435
Net interest income (GAAP)		5,001		4,814
Noninterest income		4,864		1,089
Total revenue		9,865		5,903
Provision for loan losses		600		600
Noninterest expense		7,542		3,594
Income tax expense		258		160
Net earnings	$	1,465	$	1,549
Basic and diluted earnings per share	$	0.40	$	0.43

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

Financial Summary

The Company s net earnings were $1.5 million for the first quarter of 2012, compared to $1.5 million for the first quarter of 2011. Basic and diluted earnings per share were $0.40 per share for the first quarter of 2012, compared to $0.43 per share for the first quarter of 2011.

Net interest income was $5.0 million for the first quarter of 2012, compared to $4.8 million for the first quarter of 2011. Average loans were $377.2 million in the first quarter of 2012, an increase of $4.8 million, or 1%, from the first quarter of 2011. Average deposits were $629.7 million in the first quarter of 2012, an increase of $6.9 million, or 1%, from the first quarter of 2011.

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The provision for loan losses was $0.6 million for the first quarter of 2012 and 2011. The Company s annualized net charge-off ratio was 0.02% in the first quarter of 2012, compared to 0.45% in the first quarter of 2011.

Noninterest income was $4.9 million for the first quarter of 2012, compared to $1.1 million in the first quarter of 2011. The increase in noninterest income was primarily due to a $3.3 million gain on sale of three affordable housing investments in January 2012.

Noninterest expense was $7.5 million for the first quarter of 2012, compared to $3.6 million in the first quarter of 2011. On January 19, 2012, the Company restructured its balance sheet by paying off $38.0 million of FHLB advances with a weighted average rate of 4.26% and a weighted average duration of 2.6 years. The increase in total noninterest expense was primarily due to prepayment penalties of $3.7 million incurred during the first quarter of 2012 on the repayment of the FHLB advances, compared to none in the first quarter of 2011.

Income tax expense was approximately $0.3 million for the first quarter of 2012, compared to $0.2 million in the first quarter of 2011. The Company s effective tax rate for the first quarter of 2012 was approximately 14.97%, compared to 9.36% in the first quarter of 2011. The increase in the Company s effective tax rate during the first quarter of 2012 when compared to the first quarter of 2011 was primarily due to a decrease in federal tax credits related to the Company s investments in affordable housing limited partnerships, which were sold in January 2012. The decrease in federal tax credits was partially offset by the reversal of a previously established deferred tax valuation allowance related to capital loss carryforwards.

In the first quarter of 2012, the Company paid cash dividends of $0.7 million, or $0.205 per share. The Company s balance sheet remains strong and well capitalized under current regulatory guidelines with a total risk-based capital ratio of 16.95% and a Tier 1 leverage ratio of 9.06% at March 31, 2012.

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. Loan losses are charged off 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. Allocation of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management s judgment, is deemed to be uncollectible.

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

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

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

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

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

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At March 31, 2012 and 2011, 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.

The Company periodically re-evaluates its practices in determining the allowance for loan losses. During the fourth quarter of 2011, the Company s management decided to eliminate a previously unallocated component of the allowance. As a result, the Company had no unallocated amount included in the allowance at March 31, 2012 and 2011, respectively.

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

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The Company assesses impairment for pooled trust preferred securities using a cash flow model. The key assumptions include default probabilities of the underlying collateral and recoveries on collateral defaults. These assumptions may have a significant effect on the determination of the present value of expected future cash flows and the resulting amount of other-than-temporary impairment. 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.

Fair Value Determination

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. FASB ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 8 of the Condensed Consolidated Financial Statements.

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

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

Other Real Estate Owned

Other real estate owned (OREO), consists of properties obtained through foreclosure or in satisfaction of loans and is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal realized at the time of disposal 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 experienced during 2011 and 2010. 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 historical level of taxable income 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 the Company will realize the benefits of these deductible differences at March 31, 2012. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during future periods are reduced.

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RESULTS OF OPERATIONS

Average Balance Sheet and Interest Rates

	Quarter ended March 31,					
	2012			2011		
(Dollars in thousands)		Average Balance	Yield/ Rate		Average Balance	Yield/ Rate
Loans and loans held for sale	$	379,574	5.58%	$	374,325	5.73%
Securities - taxable		218,793	2.15%		240,342	2.86%
Securities - tax-exempt		78,045	6.26%		79,852	6.49%
Total securities		296,838	3.23%		320,194	3.77%
Federal funds sold		21,605	0.26%		17,864	0.20%
Interest bearing bank deposits		1,181			2,295	
Total interest-earning assets		699,198	4.41%		714,678	4.69%
Deposits:						
NOW		98,173	0.47%		91,975	0.67%
Savings and money market		151,035	0.64%		137,601	0.75%
Certificates of deposits less than $100,000		111,231	1.72%		115,295	2.07%
Certificates of deposits and other time deposits of $100,000 or more		166,448	2.17%		189,598	2.51%
Total interest-bearing deposits		526,887	1.32%		534,469	1.65%
Short-term borrowings		3,068	0.52%		2,477	0.49%
Long-term debt		54,826	3.80%		91,728	3.74%
Total interest-bearing liabilities		584,781	1.55%		628,674	1.95%
Net interest income and margin	$	5,415	3.11%	$	5,249	2.98%

Net Interest Income and Margin

Net interest income (tax-equivalent) was $5.4 million in the first quarter of 2012, compared to $5.2 million for the first quarter of 2011, as net interest margin improvement offset a decline in average interest-earning assets of 2%. Net interest margin (tax-equivalent) was 3.11% for the first quarter of 2012, compared to 2.98% for the first quarter of 2011.

The tax-equivalent yield on total interest-earning assets decreased 28 basis points in the first quarter of 2012 from the first quarter of 2011 to 4.41%. This decrease was primarily driven by a 54 basis point decrease in the tax-equivalent yield on total securities to 3.23%.

The cost of total interest-bearing liabilities decreased 40 basis points in the first quarter of 2012 from the first quarter of 2011 to 1.55%. This decrease was primarily driven by a 33 basis point decrease in the cost of total interest-bearing deposits to 1.32%.

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 coverage for the probable losses on outstanding loans. The provisions for loan losses amounted to $0.6 million for the quarter ended March 31, 2012 and 2011, respectively.

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 probable losses in the loan portfolio. The Company s allowance for loan losses as a percentage of total loans was 1.97% at March 31, 2012, compared to 1.87% at December 31, 2011. 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 necessarily approximate and imprecise. Factors beyond our control (such as conditions in the local and national economy, local real estate market, or industry conditions) 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.

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Noninterest Income

(Dollars in thousands)	Quarter ended March 31, 2012	2011
Service charges on deposit accounts	$ 291	$ 291
Mortgage lending income	669	384
Bank-owned life insurance	99	107
Gain on sale of affordable housing investments	3,268	
Securities gains (losses), net	179	(46)
Other	358	353
Total noninterest income	$ 4,864	$ 1,089

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 release or retain the associated mortgage servicing rights (MSRs) when the loan is sold.

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

MSRs are also evaluated for impairment periodically. Impairment is determined by grouping MSRs by common predominant characteristics, such as interest rate and loan type. If the aggregate carrying amount of a particular group of MSRs exceeds the group s aggregate fair value, a valuation reserve for that group is established. The valuation reserve 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.

(Dollars in thousands)	Quarter ended March 31, 2012	2011
Origination income, net	$ 660	$ 288
Servicing fees, net	72	96
Increase in MSR valuation allowance	(63)	
Total mortgage lending income	$ 669	$ 384

Mortgage lending income was $0.7 million for the first quarter of 2012, compared to $0.4 million for the first quarter of 2011. An increase in the level of refinance and purchase activity during the first quarter of 2012 contributed to the increase in mortgage lending income. The Company s income from mortgage lending typically fluctuates as mortgage interest rates change and is primarily attributable to origination and sale of new mortgage loans.

The Company recognized a gain on sale of $3.3 million during the first quarter of 2012 related to the sale of its interests in three affordable housing limited partnerships in January 2012. Accordingly, the Company does not expect to receive any federal tax credits related to affordable housing partnership investments in 2012.

Net securities gains (losses) include realized gains and losses on the sale of securities and other-than-temporary impairment charges. Net gains on the sale of securities were approximately $309,000 for the first quarter of 2012, compared to net gains on the sale of securities of approximately $5,000 for the first quarter of 2011. On March 30, 2012, the Company sold two trust preferred securities for a net gain of $124,000. All other net gains on the sale of securities during the first quarter of 2012 were attributable to mortgage-backed securities sold. Other-than-temporary impairment charges were approximately $130,000 for the first quarter of 2012, compared to approximately $51,000 for the first quarter of 2011. For both periods, the other-than-temporary impairment charges related to trust preferred securities.

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Noninterest Expense

(Dollars in thousands)	Quarter ended March 31, 2012	2011
Salaries and benefits	$ 2,143	$ 1,930
Net occupancy and equipment	338	346
Professional fees	187	171
FDIC and other regulatory assessments	183	282
Other real estate owned, net	69	(17)
Prepayment penalty on long-term debt	3,708	
Other	914	882
Total noninterest expense	$ 7,542	$ 3,594

The increase in salaries and benefits expense reflected routine increases coupled with an increase in the number of full-time equivalent employees due to the opening of a new branch during December 2011 in Valley, Alabama.

The decrease in FDIC and other regulatory assessments expense was primarily due to the FDIC redefining the deposit insurance assessment base effective April 1, 2011. Most FDIC insured institutions with less than $10 billion in assets experienced a reduction in their FDIC deposit insurance assessments.

Net expenses related to other real estate owned were approximately $69,000 in the first quarter of 2012, compared to a net reduction in expense of $17,000 in the first quarter of 2011. The net increase in expenses was primarily due to an increase in the ongoing costs of maintenance, property taxes, and holding losses on the valuations of certain properties included in other real estate owned. These properties could also be subject to future valuation adjustments as a result of updated appraisal information and further deterioration in real estate values, thus causing additional fluctuations in other real estate owned expense, net. Additionally, the Company will continue to incur expenses associated with maintenance costs and property taxes associated with these assets.

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

Income Tax Expense

Income tax expense was approximately $0.3 million for the first quarter of 2012, compared to $0.2 million in the first quarter of 2011. The Company s effective tax rate for the first quarter of 2012 was approximately 14.97%, compared to 9.36% in the first quarter of 2011. The increase in the Company s effective tax rate during the first quarter of 2012 when compared to the first quarter of 2011 was primarily due to a decrease in federal tax credits related to the Company s investments in three affordable housing limited partnerships, which were sold in January 2012. The decrease in federal tax credits was partially offset by the reversal of a previously established deferred tax valuation allowance related to capital loss carryforwards.

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BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale were $299.9 million and $299.6 million as of March 31, 2012 and December 31, 2011, respectively. Unrealized net gains on securities available-for-sale were $6.4 million at March 31, 2012 compared to unrealized net gains of $6.7 million at December 31, 2011.

The average tax-equivalent yields earned on total securities were 3.23% in the first quarter of 2012 and 3.77% in the first quarter of 2011.

Loans

		kishore kunal	kishore kunal	kishore kunal	kishore kunal	kishore kunal
		2012		**2011**		
		First	**Fourth**	**Third**	**Second**	**First**
(In thousands)		**Quarter**	**Quarter**	**Quarter**	**Quarter**	**Quarter**
Commercial and industrial	$	56,804	54,988	53,888	52,027	51,323
Construction and land development		34,350	39,814	40,781	43,864	48,814
Commercial real estate		173,265	162,435	166,059	166,272	161,882
Residential real estate		105,183	101,725	102,030	100,496	95,997
Consumer installment		10,953	11,454	12,105	11,248	10,968
Total loans		380,555	370,416	374,863	373,907	368,984
Less: unearned income		(178)	(153)	(75)	(112)	(75)
Loans, net of unearned income	$	380,377	370,263	374,788	373,795	368,909

Total loans, net of unearned income, were $380.4 million as of March 31, 2012, compared to $370.3 million at December 31, 2011. Four loan categories represented the majority of the loan portfolio at March 31, 2012: commercial real estate (46%), residential real estate (28%), construction and land development (9%) and commercial and industrial (15%). Approximately 43% of the Company s commercial real estate loans were classified as owner-occupied at March 31, 2012.

Within the residential real estate portfolio segment, the Company had junior lien mortgages of approximately $14.9 million, or 4% of total loans, at March 31, 2012, compared to $15.1 million, or 4% of total loans, at December 31, 2011. For residential real estate mortgage loans with a consumer purpose, approximately $2.0 million and $1.8 million required interest only payments at March 31, 2012 and December 31, 2011, respectively. The Company s residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high risk consumer mortgage products.

Purchased loan participations included in the Company s loan portfolio were approximately $3.7 million and $3.8 million at March 31, 2012 and December 31, 2011, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company s normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures described under CRITICAL ACCOUNTING POLICIES Allowance for Loan Losses .

The average yield earned on loans and loans held for sale was 5.58% in the first quarter of 2012 and 5.73% in the first quarter of 2011.

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the impact of recessionary 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 laws and regulations.

The Company attempts to reduce these economic and credit risks by adhering to loan to value guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers financial position. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit our credit exposure by prohibiting unsecured loan relationships that exceed 10% of the capital accounts of the Bank; or 20% of the capital accounts if loans in excess of 10% are fully secured, the upper legal lending limit is approximately

$14.8 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a

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single borrower of $13.3 million. Our loan policy requires that the Loan Committee of the Bank s Board of Directors approve any loan relationships that exceed this internal limit. At March 31, 2012 and December 31, 2011, the Company 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 industries. We use broadly accepted industry classification systems in order to classify borrowers into various industry classifications. Loan concentrations to borrowers in the following industries exceeded 25% of the Bank s total risk-based capital at March 31, 2012 (and related balances at December 31, 2011).

	kishore kunal		kishore kunal	
(In thousands)	**March 31, 2012**		**December 31, 2011**	
Lessors of 1 to 4 family residential properties	$	44,686	$	43,767
Office buildings		19,988		20,004

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company s estimate of probable losses in the loan portfolio. At March 31, 2012 and December 31, 2011, the allowance for loan losses was $7.5 million and $6.9 million, respectively, which management deemed 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 first quarter of 2012 and the previous four quarters is presented below.

		kishore kunal		kishore kunal	kishore kunal	kishore kunal	kishore kunal
		2012			**2011**		
(Dollars in thousands)		**First Quarter**		**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Balance at beginning of period	$	6,919		6,340	7,746	7,855	7,676
Charge-offs:							
Commercial and industrial				(19)	(298)	(306)	(56)
Construction and land development				(41)	(1,572)	(112)	(33)
Commercial real estate				(4)	(79)		(339)
Residential real estate		(33)		(14)	(73)	(389)	(57)
Consumer installment		(7)		(11)	(7)	(2)	(1)
Total charge-offs		(40)		(89)	(2,029)	(809)	(486)
Recoveries		17		18	23	100	65
Net charge-offs		(23)		(71)	(2,006)	(709)	(421)
Provision for loan losses		600		650	600	600	600
Ending balance	$	7,496		6,919	6,340	7,746	7,855
as a % of loans		1.97	%	1.87	1.69	2.07	2.13
as a % of nonperforming loans		73	%	67	60	95	70
Net charge-offs as a % of average loans		0.02	%	0.08	2.14	0.76	0.45

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 1.97% at March 31, 2012, compared to 1.87% at December 31, 2011. 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 losses based on their judgement about information available to them at the time of their examinations.

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At March 31, 2012, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 73%, compared to 67% at December 31, 2011. The change was primarily due to an increase in the level of allowance for loan losses related to the commercial real estate loan portfolio segment. The increase in the allowance for loan losses was primarily due to an increase in both total loans outstanding in the commercial real estate portfolio and the valuation allowance related to impaired commercial real estate loans.

At March 31, 2012, the Company s recorded investment in loans considered impaired was $10.4 million, with a corresponding valuation allowance (included in the allowance for loan losses) of $2.0 million. At December 31, 2011, the Company s recorded investment in loans considered impaired was $11.0 million, with a corresponding valuation allowance (included in the allowance for loan losses) of $1.2 million.

Nonperforming Assets

At March 31, 2012, the Company had $17.6 million in nonperforming assets compared to $18.3 million at December 31, 2011. Included in nonperforming assets were nonperforming loans of $10.2 million and $10.4 million at March 31, 2012 and December 31, 2011, respectively. The majority of the balance in nonperforming assets at March 31, 2012 related to deterioration in the construction and land development loan portfolio.

The table below provides information concerning total nonperforming assets and certain asset quality ratios for the first quarter of 2012 and the previous four quarters.

	kishore kunal	kishore kunal	kishore kunal	kishore kunal	kishore kunal
	2012		**2011**		
(Dollars in thousands)	**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Nonperforming assets:					
Nonaccrual loans	$ 10,230	10,354	10,506	8,151	11,166
Other real estate owned	7,346	7,898	7,770	9,361	8,450
Total nonperforming assets	$ 17,576	18,252	18,276	17,512	19,616
as a % of loans and other real estate owned	4.53 %	4.83	4.78	4.57	5.20
as a % of total assets	2.31 %	2.35	2.39	2.25	2.51
Nonperforming loans as a % of total loans	2.69 %	2.80	2.80	2.18	3.03
Accruing loans 90 days or more past due	$ 231			11	158

The Lee County Association of Realtors (LCAR) of Alabama reported that the average median selling price for residential homes during the quarter ended March 31, 2012 was $154,133 a decrease of 3.1% from the same quarter a year earlier. LCAR also reported that residential inventory at March 31, 2012 was 1,221 homes, a decrease of 16.1% from a year earlier. The average number of days on the market for residential homes sold during the quarter ended March 31, 2012 was 185 days, an increase of 2.7% from the same quarter last year. Continued weakness in the real estate market and the overall economy could adversely affect the Company s volume of nonperforming assets.

The table below provides information concerning the composition of nonaccrual loans for the first quarter of 2012 and the previous four quarters.

	kishore kunal	kishore kunal	kishore kunal	kishore kunal	kishore kunal
	2012		**2011**		
(In thousands)	**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Nonaccrual loans:					
Commercial and industrial	$ 80	76	32	48	508
Construction and land development	4,504	5,095	5,156	2,844	4,043
Commercial real estate	3,362	3,457	3,616	3,868	3,954
Residential real estate	2,276	1,726	1,559	1,245	2,510
Consumer installment	8		143	146	151
Total nonaccrual loans	$ 10,230	10,354	10,506	8,151	11,166

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The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At March 31, 2012, the Company had $10.2 million in loans on nonaccrual, compared to $10.4 million at December 31, 2011.

At March 31, 2012 there was $0.2 million in loans 90 days past due and still accruing interest. At December 31, 2011, there were no loans 90 days past due and still accruing interest.

The table below provides information concerning the composition of other real estate owned for the first quarter of 2012 and the previous four quarters.

		kishore kunal	kishore kunal	kishore kunal	kishore kunal	kishore kunal
		2012		**2011**		
(In thousands)		**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Other real estate owned:						
Commercial:						
Buildings	$	615	615			
Developed lots		1,321	1,325	1,528	1,528	
Residential:						
Condominiums		3,348	3,663	3,991	5,015	5,494
New home construction		97	97	97	346	346
Developed lots		61	141	141	209	282
Undeveloped land		1,401	1,401	1,401	1,401	1,746
Other		503	656	612	862	582
Total other real estate owned	$	7,346	7,898	7,770	9,361	8,450

The Company held $7.3 million in other real estate owned at March 31, 2012, which we had acquired from borrowers, compared to $7.9 million at December 31, 2011. Other real estate owned primarily relates to four properties with a total carrying value of $6.0 million at March 31, 2012. One of the properties, with a carrying value of $2.2 million at March 31, 2012, is a completed condominium project on the Florida Gulf Coast. The Company had previously purchased a participation interest in the first lien mortgage loan on the condominium project on the Florida Gulf Coast from Silverton Bank. Subsequently, this loan defaulted and was foreclosed upon and the Company s interest in the property is currently included in other real estate owned. Following Silverton Bank s failure on May 1, 2009, the FDIC has held this property as the receiver of Silverton Bank. CB Richard Ellis, a national real estate firm, has been managing this property and selling condominiums in the project as an FDIC contractor. The Company depends upon the FDIC and CB Richard Ellis for information regarding this property and its performance. On April 26, 2012, the FDIC completed a bulk sale of the remaining condominiums and club amenities. Once the FDIC has completed its administrative processes, it will disburse the pro-rate share of the net sales proceeds to each participant. Based upon the latest information available to us, the Company expects to collect the full amount of the carrying value included in other real estate owned for this property at March 31, 2012.

Potential Problem Loans

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower s ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Federal Reserve, the Company s primary regulator, for loans classified as substandard, excluding nonaccrual loans. Potential problem loans, which are not included in nonperforming assets, amounted to $18.2 million, or 4.8% of total loans at March 31, 2012, compared to $18.5 million, or 5.0% of total loans at December 31, 2011.

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The table below provides information concerning the composition of performing potential problem loans for the first quarter of 2012 and the previous four quarters.

		kishore kunal	kishore kunal	kishore kunal	kishore kunal	kishore kunal
		2012		**2011**		
(In thousands)		**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Potential problem loans:						
Commercial and industrial	$	788	719	794	991	1,051
Construction and land development		995	1,080	1,113	5,016	5,027
Commercial real estate		9,257	9,278	9,715	9,309	5,553
Residential real estate		7,013	7,311	6,238	5,387	5,657
Consumer installment		135	128	106	109	112
Total potential problem loans	$	18,188	18,516	17,966	20,812	17,400

At March 31, 2012, approximately $0.7 million or 4.0% of total potential problem loans were past due at least 30 days but less than 90 days. At March 31, 2012, 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 first quarter of 2012 and the previous four quarters.

		kishore kunal	kishore kunal	kishore kunal	kishore kunal	kishore kunal
		2012		**2011**		
(In thousands)		**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Performing loans past due 30 to 89 days:						
Commercial and industrial	$	174	1,191	253	94	136
Construction and land development			317	173		493
Commercial real estate		258			456	419
Residential real estate		657	1,245	1,094	360	2,001
Consumer installment		99	57	25	15	60
Total	$	1,188	2,810	1,545	925	3,109

Deposits

Total deposits were $641.2 million at March 31, 2012, compared to $619.6 million at December 31, 2011. Noninterest bearing deposits were $110.9 million, or 17.3% of total deposits, at March 31, 2012, compared to $106.3 million, or 17.2% of total deposits at December 31, 2011. During the first quarter of 2012, customers continued to seek safety and liquidity in light of an uncertain national economy. The increase in noninterest bearing deposits was primarily due to an $8.3 million increase in personal and business noninterest bearing accounts. This increase was offset by a $3.4 million decrease in public depositor noninterest bearing accounts. Interest bearing deposits were $530.3 million, at March 31, 2012, compared to $513.3 million, at December 31, 2011. The increase in interest bearing deposits was primarily due to a $12.3 million increase in public depositor account balances which are generally subject to seasonal fluctuations.

The average rate paid on total interest-bearing deposits was 1.32% in the first quarter of 2012 and 1.65% in the first quarter of 2011.

Other Borrowings

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased, securities sold under agreements to repurchase, and other short-term borrowings. The Bank had available federal funds lines totaling $40.0 million with none outstanding at March 31, 2012 and December 31, 2011, respectively. Securities sold under agreements to repurchase totaled $2.8 million at March 31, 2012 and December 31, 2011, respectively.

The average rate paid on short-term borrowings was 0.52% in the first quarter of 2012 and 0.49% in the first quarter of 2011.

Long-term debt includes FHLB advances with an original maturity greater than one year, securities sold under agreements to repurchase with an original maturity greater than one year, and subordinated debentures related to trust preferred securities. The Bank had $15.0 million at March 31, 2012 and December 31, 2011, respectively, in securities sold under agreements to repurchase with an original maturity greater than one year. The Bank had $25.1 million and $63.1 million in long-term FHLB advances at March 31, 2012 and December 31, 2011, respectively, and the Company had $7.2 million in junior subordinated debentures related to trust preferred securities outstanding at both March 31, 2012 and December 31, 2011. On January 19, 2012, the Company restructured its balance sheet by paying off $38.0 million of FHLB advances with a weighted average rate of 4.26% and a weighted average duration of 2.6 years.

The average rate paid on long-term debt was 3.80% in the first quarter of 2012 and 3.74% in the first quarter of 2011.

CAPITAL ADEQUACY

The Company s consolidated stockholders equity balances were $66.0 million and $65.4 million as of March 31, 2012 and December 31, 2011, respectively. The increase from December 31, 2011 was primarily driven by net earnings of $1.5 million, which was reduced by other comprehensive losses of $0.2 million and cash dividends paid of $0.7 million.

The Company s tier 1 leverage ratio was 9.06%, tier 1 risk-based capital ratio was 15.69% and total risk-based capital ratio was 16.95% at March 31, 2012. These ratios exceed the minimum regulatory capital percentages of 5.0% for tier 1 leverage ratio, 6.0% for tier 1 risk-based capital ratio and 10.0% for total risk-based capital ratio to be considered well-capitalized. Based on current regulatory standards, the Company is classified as well capitalized.

MARKET AND LIQUIDITY RISK MANAGEMENT

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

Interest Rate Sensitivity 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 model.

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 are combined with other factors in order to produce various earnings simulations and estimates. To limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income to less than a 10 percent decline for a 200 basis point change up or down in rates from management s flat interest rate forecast over the next twelve months. The results of our current simulation model would indicate that we were in compliance with our current guidelines at March 31, 2012.

Economic value of equity measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are estimated by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case economic value of equity. To help limit interest rate risk, we have a guideline stating that for a 200 basis point instantaneous change in interest rates up or down, the economic value of equity should not decrease by more than 25 percent. The results of our current economic value of equity model would indicate that we were in compliance with our guidelines at March 31, 2012.

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. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to

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service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios in seeking satisfactory, consistent levels of profitability within the framework of the Company s established liquidity, loan, investment, borrowing, and capital policies.

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At March 31, 2012 and December 31, 2011, the Company had no derivative contracts to assist in managing interest rate sensitivity.

Liquidity Risk Management

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

Liquidity is managed at two levels. The first is the liquidity of the Company. The second is the liquidity of the Bank. The management of liquidity at both levels is essential, because the Company and the Bank are separate 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 for the Company include dividends paid to shareholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. The junior subordinated debentures are presented as long-term debt in the Consolidated Balance Sheets and the related trust preferred securities are includible in Tier 1 Capital for regulatory capital purposes.

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, sales of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB s advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. At March 31, 2012, the Bank had an available line of credit with the FHLB totaling $228.3 million with $25.1 million outstanding. At March 31, 2012, the Bank also had $40.0 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 March 31, 2012, the Bank had outstanding standby letters of credit of $7.1 million and unfunded loan commitments outstanding of $53.8 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank 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.

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As of March 31, 2012, the unpaid principal balance of the residential mortgage loans we have originated and sold was $263.1 million. Although these loans are generally sold on a non-recourse basis, except for breaches of customary seller representations and warranties, we may have to repurchase residential mortgage loans in cases where we breach such representations or warranties or the other terms of the sale, such as where we fail to deliver required documents or these documents are defective. Investors also may require the repurchase of a mortgage loan when an early payment default underwriting review reveals significant underwriting deficiencies, even if the mortgage loan has subsequently been brought current. Repurchase demands are typically reviewed on an individual loan by loan basis to validate the claims made by the investor and to determine if a contractually required repurchase event has occurred. We seek to reduce and manage the risks of potential repurchases or other claims by mortgage loan investors through our underwriting, quality assurance and servicing practices, including good communications with our residential mortgage investors.

We were not required to repurchase any residential mortgage loans in 2009, 2010 and 2011. In the first quarter of 2012, we repurchased one residential mortgage loan with an unpaid principal balance of $0.3 million. This loan was current as to principal and interest at the time of repurchase, and we incurred no losses on its repurchase.

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

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

Although to date repurchase requests related to representation and warranty provisions, and servicing activities have been limited, it is possible that requests to repurchase mortgage loans may increase in frequency as investors more aggressively pursue all means of recovering losses on their purchased loans. However, as of March 31, 2012, we believe that this exposure is not material due to the historical level of repurchase requests and loss trends and thus have not established a liability for losses related to mortgage loan repurchases. As of March 31, 2012, 99.6% of our residential mortgage loans serviced for investors were current. 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 Condensed 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 pronouncement has been issued by the FASB, but is not yet effective:

ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, expands the disclosure requirements for financial instruments and derivatives that may be offset in accordance with enforceable master netting agreements or similar arrangements. The disclosures are required regardless of whether the instruments have been offset (or netted) in the statement of financial position. Under ASU 2011-11, companies must describe the nature of offsetting arrangements and provide quantitative information about those agreements, including the gross and net amounts of financial instruments that are recognized in the statement of financial position. These changes are effective for the Company in the first quarter of 2013 with retrospective application. The Company does not expect the adoption of this Update will affect the Company s consolidated financial results since it amends only the disclosure requirements for offsetting financial instruments.

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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 of total revenue and the calculation of the efficiency ratio.

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

		kishore kunal	kishore kunal	kishore kunal	kishore kunal	kishore kunal
		2012		**2011**		
(in thousands)		**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Net interest income (GAAP)	**$**	**5,001**	**4,509**	**4,845**	**5,057**	**4,814**
Tax-equivalent adjustment		414	415	429	440	435
Net interest income (Tax-equivalent)	**$**	**5,415**	**4,924**	**5,274**	**5,497**	**5,249**

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Table 2 - Selected Quarterly Financial Data

	kishore kunal		kishore kunal	kishore kunal	kishore kunal	kishore kunal
	2012			2011		
(Dollars in thousands, except per share amounts)	First Quarter		Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Results of Operations						
Net interest income (a)	$ 5,415		4,924	5,274	5,497	5,249
Less: tax-equivalent adjustment	414		415	429	440	435
Net interest income (GAAP)	5,001		4,509	4,845	5,057	4,814
Noninterest income	4,864		1,461	1,327	1,300	1,089
Total revenue	9,865		5,970	6,172	6,357	5,903
Provision for loan losses	600		650	600	600	600
Noninterest expense	7,542		4,187	4,268	4,308	3,594
Income tax expense (benefit)	258		(32)	(63)	(8)	160
Net earnings	$ 1,465		1,165	1,367	1,457	1,549
Per share data:						
Basic and diluted net earnings	$ 0.40		0.32	0.38	0.40	0.43
Cash dividends declared	0.205		0.20	0.20	0.20	0.20
Weighted average shares outstanding:						
Basic and diluted	3,642,738		3,642,738	3,642,738	3,642,738	3,642,728
Shares outstanding, at period end	3,642,738		3,642,738	3,642,738	3,642,738	3,642,738
Book value	$ 18.11		17.96	17.69	16.77	15.87
Common stock price						
High	$ 21.99		19.65	19.70	19.91	20.37
Low	18.23		18.52	19.10	19.40	19.51
Period end:	21.99		18.52	19.65	19.75	19.56
To earnings ratio	14.66	x	12.10	13.55	14.01	13.49
To book value	121	%	103	111	118	123
Performance ratios:						
Return on average equity	8.86	%	7.15	8.81	9.90	10.84
Return on average assets	0.77	%	0.61	0.72	0.75	0.80
Dividend payout ratio	51.25	%	62.50	52.63	50.00	46.51
Asset Quality:						
Allowance for loan losses as a % of:						
Loans	1.97	%	1.87	1.69	2.07	2.13
Nonperforming loans	73	%	67	60	95	70
Nonperforming assets as a % of:						
Loans and foreclosed properties	4.53	%	4.83	4.78	4.57	5.20
Total assets	2.31	%	2.35	2.39	2.25	2.51
Nonperforming loans as a % of total loans	2.69	%	2.80	2.80	2.18	3.03
Net charge-offs as a % of average loans	0.02	%	0.08	2.14	0.76	0.45
Capital Adequacy:						
Tier 1 risk-based capital ratio	15.69	%	15.40	15.25	14.95	14.84
Total risk-based capital ratio	16.95	%	16.66	16.51	16.20	16.09
Tier 1 Leverage Ratio	9.06	%	8.82	8.87	8.65	8.56
Other financial data:						
Net interest margin (a)	3.11	%	2.77	2.98	3.09	2.98
Effective income tax rate	14.97	%	NM	NM	NM	9.36
Efficiency ratio (b)	73.37	%	65.58	64.66	63.38	56.71
Selected average balances:						
Securities	$ 296,838		294,485	292,027	305,564	320,194
Loans, net of unearned income	377,164		372,318	375,614	375,192	372,319
Total assets	756,833		766,907	763,771	777,181	776,795
Total deposits	629,653		610,543	610,961	625,941	622,720
Long-term debt	54,826		85,314	85,319	85,323	91,728
Total stockholders equity	66,118		65,168	62,041	58,888	57,171
Selected period end balances:						
Securities	$ 299,902		299,582	283,070	296,443	321,098
Loans, net of unearned income	380,377		370,263	374,788	373,795	368,909

Allowance for loan losses	7,496	6,919	6,340	7,746	7,855
Total assets	760,522	776,218	764,637	779,725	781,557
Total deposits	641,195	619,552	609,070	627,969	631,394
Long-term debt	47,308	85,313	85,317	85,322	85,327
Total stockholders equity	65,972	65,416	64,422	61,100	57,801

(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 ineterest income.

NM - not meaningful

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Table 3 - Average Balances and Net Interest Income Analysis

	kishore k	kishore k	kishore k	kishore k	kishore k	kishore k
	Quarter ended March 31,					
		2012			2011	
(Dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Interest-earning assets:						
Loans and loans held for sale (1)	$ 379,574	$ 5,265	5.58%	$ 374,325	$ 5,287	5.73%
Securities - taxable	218,793	1,168	2.15%	240,342	1,695	2.86%
Securities - tax-exempt (2)	78,045	1,215	6.26%	79,852	1,278	6.49%
Total securities	296,838	2,383	3.23%	320,194	2,973	3.77%
Federal funds sold	21,605	14	0.26%	17,864	9	0.20%
Interest bearing bank deposits	1,181			2,295		
Total interest-earning assets	699,198	$ 7,662	4.41%	714,678	$ 8,269	4.69%
Cash and due from banks	14,890			13,715		
Other assets	42,745			48,402		
Total assets	$ 756,833			$ 776,795		
Interest-bearing liabilities:						
Deposits:						
NOW	$ 98,173	$ 115	0.47%	$ 91,975	$ 152	0.67%
Savings and money market	151,035	239	0.64%	137,601	255	0.75%
Certificates of deposits less than $100,000	111,231	475	1.72%	115,295	588	2.07%
Certificates of deposits and other time deposits of $100,000 or more	166,448	896	2.17%	189,598	1,175	2.51%
Total interest-bearing deposits	526,887	1,725	1.32%	534,469	2,170	1.65%
Short-term borrowings	3,068	4	0.52%	2,477	3	0.49%
Long-term debt	54,826	518	3.80%	91,728	847	3.74%
Total interest-bearing liabilities	584,781	$ 2,247	1.55%	628,674	$ 3,020	1.95%
Noninterest-bearing deposits	102,766			88,251		
Other liabilities	3,168			2,699		
Stockholders equity	66,118			57,171		
Total liabilities and stockholders equity	$ 756,833			$ 776,795		
Net interest income and margin		$ 5,415	3.11%		$ 5,249	2.98%

(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%.

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Table 4 - Loan Portfolio Composition

	kishore kunal	kishore kunal	kishore kunal	kishore kunal	kishore kunal
	2012		**2011**		
(In thousands)	**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Commercial and industrial	$ 56,804	54,988	53,888	52,027	51,323
Construction and land development	34,350	39,814	40,781	43,864	48,814
Commercial real estate	173,265	162,435	166,059	166,272	161,882
Residential real estate	105,183	101,725	102,030	100,496	95,997
Consumer installment	10,953	11,454	12,105	11,248	10,968
Total loans	380,555	370,416	374,863	373,907	368,984
Less: unearned income	(178)	(153)	(75)	(112)	(75)
Loans, net of unearned income	380,377	370,263	374,788	373,795	368,909
Less: allowance for loan losses	(7,496)	(6,919)	(6,340)	(7,746)	(7,855)
Loans, net	$ 372,881	363,344	368,448	366,049	361,054

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Table 5 - Allowance for Loan Losses and Nonperforming Assets

	kishore kunal		kishore kunal	kishore kunal	kishore kunal	kishore kunal
	2012		**2011**			
(Dollars in thousands)	**First Quarter**		**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Allowance for loan losses:						
Balance at beginning of period	$ 6,919		6,340	7,746	7,855	7,676
Charge-offs:						
Commercial and industrial			(19)	(298)	(306)	(56)
Construction and land development			(41)	(1,572)	(112)	(33)
Commercial real estate			(4)	(79)		(339)
Residential real estate	(33)		(14)	(73)	(389)	(57)
Consumer installment	(7)		(11)	(7)	(2)	(1)
Total charge-offs	(40)		(89)	(2,029)	(809)	(486)
Recoveries	17		18	23	100	65
Net charge-offs	(23)		(71)	(2,006)	(709)	(421)
Provision for loan losses	600		650	600	600	600
Ending balance	$ 7,496		6,919	6,340	7,746	7,855
as a % of loans	1.97	%	1.87	1.69	2.07	2.13
as a % of nonperforming loans	73	%	67	60	95	70
Net charge-offs as a % of average loans	0.02	%	0.08	2.14	0.76	0.45
Nonperforming assets:						
Nonaccrual loans	$ 10,230		10,354	10,506	8,151	11,166
Other real estate owned	7,346		7,898	7,770	9,361	8,450
Total nonperforming assets	$ 17,576		18,252	18,276	17,512	19,616
as a % of loans and other real estate owned	4.53	%	4.83	4.78	4.57	5.20
as a % of total assets	2.31	%	2.35	2.39	2.25	2.51
Nonperforming loans as a % of total loans	2.69	%	2.80	2.80	2.18	3.03
Accruing loans 90 days or more past due	$ 231				11	158

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Table 6 - Allocation of Allowance for Loan Losses

	2012		2011							
	First Quarter		Fourth Quarter		Third Quarter		Second Quarter		First Quarter	
(Dollars in thousands)	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial and industrial	$ 845	14.9	$ 948	14.8	$ 762	14.4	$ 767	13.9	$ 1,142	13.9
Construction and land development	1,439	9.0	1,470	10.7	1,138	10.9	2,759	11.7	2,257	13.2
Commercial real estate	3,816	45.5	3,009	43.9	2,643	44.3	2,722	44.5	2,697	43.9
Residential real estate	1,332	27.6	1,363	27.5	1,404	27.2	1,104	26.9	1,284	26.0
Consumer installment	64	2.9	129	3.1	178	3.2	190	3.0	202	3.0
Unallocated					215		204		273	
Total allowance for loan losses	$ 7,496		$ 6,919		$ 6,340		$ 7,746		$ 7,855	

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

Table 7 - CDs and Other Time Deposits of $100,000 or More

(Dollars in thousands)		**March 31, 2012**
Maturity of:		
3 months or less	$	15,827
Over 3 months through 6 months		27,206
Over 6 months through 12 months		43,282
Over 12 months		51,422
Total CDs and other time deposits of $100,000 or more	$	137,737

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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 Principal Financial and Accounting 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 Principal Financial and Accounting 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 business, the Company and the Bank from time to time are involved in legal proceedings. The Company and Bank 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, 2011.

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 our annual report on Form 10-K for the year ended December 31, 2011, 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

ISSUER PURCHASES OF EQUITY SECURITIES

Period[1]	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
January 1 - January 31				
February 1 - February 29				
March 1 - March 31				
Total				

(1) Based on trade date, not settlement date.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS

Exhibit Number	Description
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, Vice President, Controller and Chief Financial Officer (Principal Financial and Accounting 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 David A. Hedges, Vice President, Controller and Chief Financial Officer (Principal Financial and Accounting Officer).***
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 E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.***
101.INS	XBRL Instance Document****
101.SCH	XBRL Taxonomy Extension Schema Document****
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document****
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document****
101.LAB	XBRL Taxonomy Extension Label Linkbase Document****
101.PRE	XBRL Taxonomy Extension Presentation 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.

**** Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or propsectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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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: May 15, 2012   By: /s/ E. L. Spencer, Jr.
E. L. Spencer, Jr.
President, Chief Executive Officer and

Chairman of the Board

Date: May 15, 2012   By: /s/ David A. Hedges
David A. Hedges
VP, Controller and Chief Financial Officer

(Principal Financial and Accounting Officer)