AUBURN NATIONAL BANCORPORATION INC
Form 10-Q
August 13, 2009
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**
For the quarterly period ended June 30, 2009

¨ **Transition report pursuant to Section 13 or 15(d) of the Exchange Act**
For the transition period ______ to ______

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**63-0885779**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

100 N. Gay Street

Auburn, Alabama 36830

(334) 821-9200

(Address and telephone number of principal executive offices)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

Large Accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

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

Class	**Outstanding at July 31, 2009**
Common Stock, $0.01 par value per share	3,644,097 shares

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

INDEX

PART I. FINANCIAL INFORMATION		PAGE
Item 1	Financial Statements	
	Condensed Consolidated Balance Sheets (Unaudited) as June 30, 2009 and December 31, 2008	3
	Condensed Consolidated Statements of Earnings (Unaudited) for the quarter and six months ended June 30, 2009 and 2008	4
	Condensed Consolidated Statement of Stockholders Equity and Comprehensive Income (Unaudited) for the six months ended June 30, 2009 and 2008	5
	Condensed Consolidated Statements of Cash Flows (Unaudited) for the six months ended June 30, 2009 and 2008	6
	Notes to Condensed Consolidated Financial Statements	7
Item 2	Management s Discussion and Analysis of Financial Condition and Results of Operations	22
	Explanation of Use of Non-GAAP Financial Measures	34
	Selected Quarterly Financial Data	36
	Selected Financial Data	37
	Average Balances and Net Interest Income Analysis for the quarters ended June 30, 2009 and 2008	38
	Average Balances and Net Interest Income Analysis for the six months ended June 30, 2009 and 2008	39
	Loan Portfolio Composition	40
	Allowance for Loan Losses and Nonperforming Assets	41
	Allocation of Allowance for Loan Losses	42
	CDs and Other Time Deposits of $100,000 or more	43
Item 3	Quantitative and Qualitative Disclosures About Market Risk	44
Item 4	Controls and Procedures	44
PART II. OTHER INFORMATION		
Item 1	Legal Proceedings	45
Item 1A	Risk Factors	45
Item 2	Unregistered Sales of Equity Securities and Use of Proceeds	45
Item 3	Defaults Upon Senior Securities	45
Item 4	Submission of Matters to a Vote of Security Holders	45
Item 5	Other Information	46
Item 6	Exhibits	46

2

Table of Contents

PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(Unaudited)

(Dollars in thousands, except share data)	June 30, 2009	December 31, 2008
Assets:		
Cash and due from banks	$ 28,885	$ 14,832
Federal funds sold		20,755
Interest bearing bank deposits	1,972	846
Cash and cash equivalents	30,857	36,433
Securities available-for-sale	349,472	302,656
Loans held for sale	6,126	3,819
Loans, net of unearned income	373,221	369,162
Allowance for loan losses	(4,646)	(4,398)
Loans, net	368,575	364,764
Premises and equipment, net	8,433	7,778
Bank-owned life insurance	15,503	15,295
Other real estate	5,149	324
Other assets	16,795	14,901
Total assets	$ 800,910	$ 745,970
Liabilities:		
Deposits:		
Noninterest-bearing	$ 83,208	$ 78,013
Interest-bearing	533,234	472,830
Total deposits	616,442	550,843
Federal funds purchased and securities sold under agreements to repurchase	9,541	10,910
Long-term debt	118,358	123,368
Accrued expenses and other liabilities	3,621	3,721
Total liabilities	747,962	688,842
Stockholders equity:		
Preferred stock of $.01 par value; authorized 200,000 shares; issued shares - none		
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,751	3,749

Retained earnings		59,075		59,283
Accumulated other comprehensive loss, net		(3,305)		603
Less treasury stock, at cost - 313,038 shares and 310,188 shares for June 30, 2009 and December 31, 2008, respectively		(6,612)		(6,546)
Total stockholders equity		52,948		57,128
Total liabilities and stockholders equity	$	800,910	$	745,970

See accompanying notes to condensed consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Earnings

(Unaudited)

(Dollars in thousands, except share and per share data)	Quarter ended June 30 2009	2008	Six months ended June 30 2009	2008
Interest income:				
Loans, including fees	$ 5,430	$ 5,564	$ 10,776	$ 11,366
Securities	3,809	3,983	7,733	7,896
Federal funds sold and interest bearing bank deposits	9	40	15	64
Total interest income	9,248	9,587	18,524	19,326
Interest expense:				
Deposits	3,505	3,804	7,029	7,873
Short-term borrowings	15	43	31	139
Long-term debt	1,209	1,268	2,420	2,521
Total interest expense	4,729	5,115	9,480	10,533
Net interest income	4,519	4,472	9,044	8,793
Provision for loan losses	700	180	1,250	240
Net interest income after provision for loan losses	3,819	4,292	7,794	8,553
Noninterest income:				
Service charges on deposit accounts	302	297	605	608
Mortgage lending	1,310	426	2,640	896
Bank-owned life insurance	110	116	208	238
Securities (losses) gains, net (includes credit losses of $1,117 and $2,805 for debt securities, consisting of total other-than-temporary impairment losses of $2,752 and $4,440, net of $1,635 (before taxes) recognized in other comprehensive income, for the quarter and six months ended June 30, 2009, respectively)	(758)	52	(2,881)	95
Other	299	425	602	852
Total noninterest income	1,263	1,316	1,174	2,689
Noninterest expense:				
Salaries and benefits	1,974	1,721	4,023	3,574
Net occupancy and equipment	395	327	739	633
Professional fees	174	158	335	316
Other	1,381	899	2,380	1,731
Total noninterest expense	3,924	3,105	7,477	6,254
Earnings before income taxes	1,158	2,503	1,491	4,988
Income tax expense	226	636	313	1,270
Net earnings	$ 932	$ 1,867	$ 1,178	$ 3,718
Net earnings per share:				

Basic and diluted	$ 0.25	$ 0.51	$ 0.32	$ 1.01
Weighted average shares outstanding:				
Basic and diluted	3,644,491	3,680,144	3,645,652	3,680,977

See accompanying notes to condensed consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Stockholders Equity and Comprehensive Income

(Unaudited)

(Dollars in thousands, except share and per share data)	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Treasury stock	Total
Balance, December 31, 2007	3,957,135	$ 39	$ 3,748	$ 55,362	$ (397)	$ (5,734)	$ 53,018
Comprehensive income:							
Net earnings				3,718			3,718
Other comprehensive loss due to change in unrealized loss on securities available for sale, net					(1,932)		(1,932)
Total comprehensive income				3,718	(1,932)		1,786
Cash dividends paid ($0.37 per share)				(1,362)			(1,362)
Stock repurchases (3,986 shares)						(90)	(90)
Balance, June 30, 2008	3,957,135	$ 39	$ 3,748	$ 57,718	$ (2,329)	$ (5,824)	$ 53,352
Balance, December 31, 2008	3,957,135	$ 39	$ 3,749	$ 59,283	$ 603	$ (6,546)	$ 57,128
Comprehensive income:							
Net earnings				1,178			1,178
Other comprehensive loss due to other-than-temporary impairment losses related to factors other than credit on securities available-for-sale, net					(1,031)		(1,031)
Other comprehensive loss due to all other unrealized losses on securities available-for-sale, net					(2,877)		(2,877)
Total comprehensive loss				1,178	(3,908)		(2,730)
Cash dividends paid ($0.38 per share)				(1,386)			(1,386)
Stock repurchases (2,955 shares)						(67)	(67)
Sale of treasury stock (105 shares)			2			1	3
Balance, June 30, 2009	3,957,135	$ 39	$ 3,751	$ 59,075	$ (3,305)	$ (6,612)	$ 52,948

See accompanying notes to condensed consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	**Six months ended June 30 2009**	**2008**
Cash flows from operating activities:		
Net earnings	$ 1,178	$ 3,718
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	1,250	240
Depreciation and amortization	327	175
Premium amortization and discount accretion, net	764	(28)
Net loss (gain) on securities	2,881	(95)
Net gain on sale of loans held for sale	(2,474)	(308)
Net gain on sale of other real estate	(33)	
Loans originated for sale	(106,894)	(42,749)
Proceeds from sale of loans	106,353	42,468
Increase in cash surrender value of bank owned life insurance	(208)	(238)
Net increase in other assets	(1,049)	(744)
Net (decrease) increase in accrued expenses and other liabilities	(100)	153
Net cash provided by operating activities	1,995	2,592
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	89,703	25,926
Proceeds from maturities of securities available-for-sale	75,754	40,283
Purchase of securities available-for-sale	(220,133)	(74,639)
Net increase in loans	(10,110)	(23,516)
Net purchases of premises and equipment	(813)	(113)
Proceeds from sale of other real estate	258	
Net cash used in investing activities	(65,341)	(32,059)
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	5,195	6,290
Net increase in interest-bearing deposits	60,404	41,617
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(1,369)	(13,738)
Proceeds from issuance of long-term debt		8,000
Repayments or retirement of long-term debt	(5,010)	(9)
Proceeds from sale of treasury stock	3	
Stock repurchases	(67)	(90)
Dividends paid	(1,386)	(1,362)
Net cash provided by financing activities	57,770	40,708
Net change in cash and cash equivalents	(5,576)	11,241
Cash and cash equivalents at beginning of period	36,433	13,498

Cash and cash equivalents at end of period	$ 30,857	$ 24,739
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 9,413	$ 10,240
Income taxes	1,308	1,584
Supplemental disclosure of non-cash transactions:		
Real estate acquired through foreclosure	5,049	323

See accompanying notes to condensed consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

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

Basis of Presentation and Use of Estimates

The unaudited condensed consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The unaudited condensed consolidated financial statements include, in the opinion of management, all adjustments necessary to present a fair statement of the financial position and the results of operations for all periods presented. All such adjustments are of a normal recurring nature. The results of operations as of and for the six months ended June 30, 2009, are not necessarily indicative of the results of operations that the Company and its subsidiaries may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company s annual report on Form 10-K for the year ended December 31, 2008.

Reclassifications

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

Current Accounting Developments

In the first quarter of 2009, the Company adopted the following new accounting pronouncements:

- SFAS No. 141R (revised 2007), Business Combinations ;
- SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 ;
- SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 ;
- FASB Staff Position (FSP) FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly ; and
- FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments .

In the second quarter of 2009, the Company adopted the following new accounting pronouncements:

- FSP FAS 107-1 and APB Opinion 28-1, Interim Disclosures about Fair Value of Financial Instruments ; and
- SFAS No. 165, Subsequent Events .

SFAS No. 141R clarifies the definitions of both a business combination and a business. All business combinations will be accounted for under the acquisition method (previously referred to as the purchase method). This standard defines the acquisition date as the only relevant date for recognition and measurement of the fair value of consideration paid. SFAS No. 141R requires the acquirer to expense all acquisition related costs. SFAS No. 141R will also require acquired loans to be recorded net of the allowance for loan losses on the date of acquisition. SFAS No. 141R defines the measurement period as the time after the acquisition date during which the acquirer may make adjustments to the provisional amounts recognized at the acquisition date. This period cannot exceed one year, and any subsequent adjustments made to provisional amounts are done retrospectively and restate prior period data. Adoption of SFAS No. 141R in the first quarter of 2009 did not have a significant impact on the consolidated financial statements of the Company.

SFAS No. 160 requires noncontrolling interests to be treated as a separate component of equity, not as a liability or other item outside of equity. Disclosure requirements include net income and comprehensive income to be displayed for both the controlling and noncontrolling interests and a separate schedule that shows the effects of any transactions with the

Table of Contents

noncontrolling interests on the equity attributable to the controlling interest. Adoption of SFAS No. 160 in the first quarter of 209 did not have a significant impact on the consolidated financial statements of the Company.

SFAS No. 161, which amends FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities , requires companies with derivative instruments to disclose information about how and why a company uses derivative instruments, how derivative instruments and related hedge items are accounted for under Statement 133, and how derivative instruments and related hedged items affect a company s financial position, financial performance, and cash flows. The required disclosures include the fair value of the derivative instruments and their gains or losses in tabular format, information about credit-risk-related contingent features in derivative agreements, counterparty credit risk, and the company s strategies and objectives for using derivative instruments. The Statement expands the current disclosure framework in SFAS No. 133. Adoption of SFAS No. 161 in the first quarter of 2009 impacted disclosures only and did not have a significant impact on the consolidated financial statements of the Company.

FSP FAS 157-4 provides factors that an entity should consider when determining whether a market for an asset is not active. If after evaluating the relevant factors, the evidence indicates that a market is not active, FSP FAS 157-4 provides an additional list of factors that an entity must consider when determining whether events and circumstances indicate that a transaction which occurred in such inactive market is orderly. FSP FAS 157-4 requires that entities place more weight on observable transactions determined to be orderly and less weight on transactions for which there is insufficient information to determine whether the transaction is orderly when determining the fair value of an asset or liability under Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). FSP FAS 157-4 requires enhanced disclosures, including disclosure of a change in valuation technique which results from its application and disclosure of fair value measurements for debt and equity securities by major security types. The provisions of this FSP were effective in the second quarter of 2009; however, as permitted under the pronouncement, the Company early adopted in the first quarter of 2009 and the effects of adoption were not significant.

FSP FAS 115-2 replaces the intent and ability to hold to recovery indicator of other-than-temporary impairment in FASB Staff Position No. FAS 115-1 and 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1) for debt securities. FSP FAS 115-2 specifies that for a debt security not to be considered other-than-temporarily impaired, an entity s management must assert that it does not intend to sell the security and that it is not more-likely-than-not that the entity will have to sell the security prior to recovery of its cost basis. FSP FAS 115-2 requires that for impaired held-to-maturity and available-for-sale debt securities that an entity does not intend to sell and that it is not more-likely-than-not that it will have to sell prior to recovery but for which credit losses exist, the other-than-temporary impairment should be separated between the total impairment related to credit losses, which should be recognized in current earnings, and the amount of impairment related to all other factors, which should be recognized in other comprehensive income. FSP FAS 115-2 discusses the proper interaction of its guidance with other authoritative guidance, including FSP FAS 115-1, which provide additional factors that must be considered in an other-than-temporary impairment analysis. FSP FAS 115-2 also provides that in periods in which other-than-temporary impairments are recognized, the total impairment must be presented in the investor s income statement with an offset for the amount of total impairment that is recognized in other comprehensive income. FSP FAS 115-2 requires additional disclosures including a rollforward of amounts recognized in earnings for debt securities for which an other-than-temporary impairment has been recognized and the noncredit portion of the other-than-temporary impairment that has been recognized in other comprehensive income. The provisions of this FSP were effective in the second quarter of 2009; however, as permitted under the pronouncement, the Company early adopted in the first quarter of 2009. No adjustment was made to the beginning balance of retained earnings. For more information on the effects of adoption, see Note 4 for additional disclosures included in accordance with FSP FAS 115-2 and 124-2.

FSP FAS 107-1 and APB Opinion 28-1, Interim Disclosures about Fair Value of Financial Instruments, requires disclosures about fair value of financial instruments in interim reporting periods of publicly traded companies that were previously only required to be disclosed in annual financial statements. The FSP was effective for interim and annual periods ending after June 15, 2009. Accordingly, the Company adopted this FSP in the second quarter of 2009. The adoption of FSP FAS 107-1 has impacted disclosures only and has not had an impact on the financial position or results of operations of the Company. See Note 6 for additional disclosures included in accordance with FSP FAS 107-1.

SFAS No. 165, Subsequent Events , establishes general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS No. 165 was effective for periods ending after June 15, 2009. Accordingly, the Company adopted this standard in the second quarter of 2009 and has evaluated any subsequent events through the date of this filing. The Company does not believe there are any material subsequent events which would require further disclosure. Adoption of SFAS No. 165 did not have a significant impact on the consolidated financial statements of the Company.

Table of Contents

NOTE 2: BASIC AND DILUTED EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the quarter and six months ended June 30, 2009 and 2008, respectively. Diluted net earnings per share reflect the potential dilution that could occur if the Company s potential common stock was issued. At June 30, 2009 and 2008, respectively, the Company had no options issued or outstanding.

A reconciliation of the numerator and denominator of the basic earnings per share computation to the diluted earnings per share computation for the quarter and six months ended June 30, 2009 and 2009 are presented below.

(Dollars in thousands, except share and per share data)	**Quarter ended June 30** 2009	2008	**Six Months ended June 30** 2009	2008
Basic:				
Net earnings	$ 932	$ 1,867	$ 1,178	$ 3,718
Average common shares outstanding	3,644,491	3,680,144	3,645,652	3,680,977
Earnings per share	$ 0.25	$ 0.51	$ 0.32	$ 1.01
Diluted:				
Net earnings	$ 932	$ 1,867	$ 1,178	$ 3,718
Average common shares outstanding	3,644,491	3,680,144	3,645,652	3,680,977
Dilutive effect of options issued				
Average diluted shares outstanding	3,644,491	3,680,144	3,645,652	3,680,977
Earnings per share	$ 0.25	$ 0.51	$ 0.32	$ 1.01

NOTE 3: COMPREHENSIVE INCOME

Comprehensive income is defined as the change in equity from all transactions other than those with shareholders, and it includes net earnings and other comprehensive income. Comprehensive income for the quarter and six months ended June 30, 2009 and 2008 is presented below.

(In thousands)	**Quarter ended June 30** 2009	2008	**Six Months ended June 30** 2009	2008
Comprehensive income:				
Net earnings	$ 932	$ 1,867	$ 1,178	$ 3,718
Other comprehensive loss:				
Other-than-temporary impairment losses related to factors other than credit on securities available for sale, net	(1,031)		(1,031)	
Change in unrealized losses due to all other unrealized losses on securities available for sale, net	(1,419)	(4,036)	(2,877)	(1,932)
Total comprehensive (loss) income	$ (1,518)	$ (2,169)	$ (2,730)	$ 1,786

Table of Contents

NOTE 4: SECURITIES

At June 30, 2009 and December 31, 2008, all securities within the scope of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale at June 30, 2009 and December 31, 2008, by contractual maturity are presented below.

					June 30, 2009			
(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Losses	Amortized cost
Available-for-sale:								
Agency obligations (a)	$		34,341	46,343	80,684	208	1,253	81,729
Agency ABS (a)				3,752	3,752		35	3,787
Agency RMBS (a)			7,280	177,424	184,704	2,706	650	182,648
State and political subdivisions		394	16,243	58,736	75,373	300	2,476	77,549
Trust preferred securities:								
Pooled				365	365		1,635	2,000
Individual issuer				1,317	1,317		2,178	3,495
Corporate debt		2,370	907		3,277		225	3,502
Total available-for-sale	$	2,764	58,771	287,937	349,472	3,214	8,452	354,710

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

					December 31, 2008			
(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Losses	Amortized cost
Available-for-sale:								
Agency obligations (a)	$		26,679	41,322	68,001	1,140		66,861
Agency RMBS (a)		3,522	24,949	126,608	155,079	4,228	80	150,931
Private label RMBS			3,088	2,491	5,579		152	5,731
State and political subdivisions		163	15,551	49,578	65,292	685	1,766	66,373
Trust preferred securities:								
Pooled				1,715	1,715		1,260	2,975
Individual issuer				3,559	3,559		1,766	5,325
Corporate debt		2,450	981		3,431		72	3,503
Total available-for-sale	$	6,135	71,248	225,273	302,656	6,053	5,096	301,699

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

Securities with aggregate fair values of $249.9 million and $204.1 million at June 30, 2009 and December 31, 2008, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

Included in other assets are cost-method investments. The carrying amounts of cost-method investments were $6.0 million and $7.9 million at June 30, 2009 and December 31, 2008, respectively. Cost-method investments primarily include Federal Home Loan Bank (FHLB) of Atlanta stock and Federal Reserve Bank stock.

10

Table of Contents

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at June 30, 2009 and December 31, 2008, respectively, segregated by those securities that have been in an unrealized loss position for less than twelve months and twelve months or more are presented below.

		Less than 12 months		12 months or longer		Total	
(Dollars in thousands)		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2009:							
Agency obligations	$	67,423	1,253			67,423	1,253
Agency ABS		3,752	35			3,752	35
Agency RMBS		60,861	649	125	1	60,986	650
State and political subdivisions		46,210	1,565	7,238	911	53,448	2,476
Trust preferred securities:							
Pooled		365	1,635			365	1,635
Individual issuer		597	825	675	1,353	1,272	2,178
Corporate debt				3,278	225	3,278	225
Total	$	179,208	5,962	11,316	2,490	190,524	8,452
December 31, 2008:							
Agency obligations	$						
Agency RMBS		6,367	40	4,162	40	10,529	80
Private label RMBS		5,579	152			5,579	152
State and political subdivisions		30,254	1,626	1,178	140	31,432	1,766
Trust preferred securities:							
Pooled		740	1,260			740	1,260
Individual issuer		2,524	1,351	1,035	415	3,559	1,766
Corporate debt		3,431	72			3,431	72
Total	$	48,895	4,501	6,375	595	55,270	5,096

The applicable date for determining when securities are in an unrealized loss position is June 30, 2009. As such, it is possible that a security had a market value that exceeded its amortized cost on other days during the past twelve-month period.

For the securities in the above table, the Company does not have the intent to sell and have 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 has assessed 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.

To the extent the Company estimates future expected cash flows, the Company considered all available information in developing those expected cash flows. For asset-backed securities such as pooled trust preferred securities, such information generally included:

- remaining payment terms of the security (including as applicable, terms that require underlying obligor payments to increase in the future);
- current delinquencies and nonperforming assets of underlying collateral;
- expected future default rates;
- subordination levels or other credit enhancements.

Agency obligations

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

Agency asset-backed securities (ABS)

The unrealized losses associated with Agency ABS are primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities are issued by U.S. government agencies or government-sponsored entities and do 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 are primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities are issued by U.S. government agencies or government-sponsored entities and do 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 are primarily driven by changes in interest rates and are 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.

Pooled trust preferred securities

The unrealized losses associated with pooled trust preferred securities are primarily driven by higher projected collateral losses and wider credit spreads. Pooled trust preferred securities primarily consist of securities issued by community banks and thrifts. The Company assesses impairment for these securities using a cash flow model. The key assumptions include default probabilities of the underlying collateral and recoveries on collateral defaults. Based upon the Company s assessment of the expected credit losses for these securities, and given the performance of the underlying collateral compared to the Company s credit enhancement, the Company expects to recover the remaining amortized cost basis of these securities.

Individual issuer trust preferred securities

The unrealized losses associated with individual issuer trust preferred securities are primarily 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 entire amortized cost basis of these securities.

Table of Contents

Corporate debt securities

The unrealized losses associated with corporate debt securities are primarily related to securities backed by an individual issuer community bank. The Company 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 entire amortized cost basis of these securities.

Cost-method investments

At June 30, 2009, cost-method investments with an aggregate cost of $6.0 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 underlying performance of the collateral for pooled trust preferred securities, the financial condition of individual issuers of trust preferred securities, or 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 given the current economic environment.

The table below shows the applicable credit ratings, fair values, gross unrealized losses, and life-to-date impairment charges for pooled and individual issuer trust preferred securities at June 30, 2009 and December 31, 2008, respectively, segregated by those securities that have been in an unrealized loss position for less than twelve months and twelve months or more.

Trust Preferred Securities as of June 30, 2009

	Credit Rating			Unrealized losses			Life-to-date
(Dollars in thousands)	**Moody s**	**Fitch**	**Fair value**	**Less than 12 months**	**12 months or longer**	**Total**	**Impairment Charges**
Pooled:							
ALESCO Preferred Funding XVII, Ltd. (a)	Ca	B	$ 240	$ 1,160		1,160	$ 600
U.S. Capital Funding IV, Ltd. (b)	Ca	CC	125	475		475	1,900
Total pooled			365	1,635		1,635	2,500
Individual issuer (c):							
Carolina Financial Capital Trust I	n/a	n/a	135		315	315	
Main Street Bank Statutory Trust I (d)	n/a	n/a	225	275		275	
MNB Capital Trust I	n/a	n/a	125		375	375	
PrimeSouth Capital Trust I	n/a	n/a	50		450	450	
TCB Trust	n/a	n/a	287		213	213	
United Community Capital Trust	n/a	n/a	450	550		550	
Total individual issuer			1,272	825	1,353	2,178	
Total trust preferred securities			$ 1,637	$ 2,460	1,353	3,813	$ 2,500

n/a - not applicable, securities not rated.

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

(b) Class B-2 Fixed/Floating Rate Senior Surbordinate Notes. The underlying collateral is primarily composed of community banks and thrifts.

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

(d) Issuer acquired by BB&T Corporation.

Table of Contents

Trust Preferred Securities as of December 31, 2008

	Credit Rating			Unrealized losses			Life-to-date
				Less than	12 months		Impairment
(Dollars in thousands)	Moody s	Fitch	Fair value	12 months	or longer	Total	Charges
Pooled:							
ALESCO Preferred Funding XVII, Ltd. (a)	Aa2	AA	$ 740	$ 1,260		1,260	$
U.S. Capital Funding IV, Ltd. (b)	Caa3	A-	975				1,525
Total pooled			1,715	1,260		1,260	1,525
Individual issuer (c):							
Carolina Financial Capital Trust I	n/a	n/a	329	121		121	
Community Financial Services Trust II (d)	n/a	n/a	272	228		228	
Community Financial Services Trust IV (d)	n/a	n/a	492	433		433	
Crescent Capital Trust II	n/a	n/a	272		178	178	
Main Street Bank Statutory Trust I (e)	n/a	n/a	422	78		78	
MNB Capital Trust I	n/a	n/a	408	92		92	
PrimeSouth Capital Trust I	n/a	n/a	366		134	134	
TCB Trust	n/a	n/a	397		103	103	
United Community Capital Trust	n/a	n/a	601	399		399	
Total individual issuer			3,559	1,351	415	1,766	
Total trust preferred securities			$ 5,274	$ 2,611	415	3,026	$ 1,525

n/a - not applicable, securities not rated.

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

(b) Class B-2 Fixed/Floating Rate Senior Surbordinate Notes. The underlying collateral is primarily composed of community banks and thrifts.

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

(d) Community Financial Services now known as Silverton.

(e) Issuer acquired by BB&T Corporation.

For pooled trust preferred securities, the Company estimated expected future cash flows of the security by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which consider default probabilities derived from issuer credit ratings for the underlying collateral). The probability-weighted expected future cash flows of the security are then discounted at the interest rate used to recognize income on the security to arrive at a present value amount.

Subordination is defined as the amount of performing collateral that is in excess of what is needed to payoff a specified class of securities and all classes senior to the specified class. Performing collateral is defined as total collateral minus all collateral that is currently deferring or and all collateral that is currently in default. This definition assumes that all collateral that is currently deferring will default with a zero recovery rate. The underlying issuers can cure, or the bonds could recover a higher percentage upon default than zero. Subordination, as defined previously, does not consider any excess interest spread that is built into the structure of the security, which provides a source of repayment for the bonds in addition to subordination.

The table below provides a detail of subordination levels for the Company s pooled trust preferred securities at June 30, 2009 and December 31, 2008.

(Dollars in thousands)	**June 30, 2009**	**December 31, 2008**
ALESCO Preferred Funding XVII, Ltd. - Class B notes		
Subordination level	$ 78,516	$ 115,874
Subordination as a % of performing collateral	23.95%	31.58%

There was no excess subordination for U.S. Capital Funding IV, Ltd., B-2 notes at June 30, 2009 and December 31, 2008, respectively.

Other-Than-Temporarily Impaired 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 on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses).

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.

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 impairment recognized in earnings for the six months ended June 30, 2009 for credit-impaired debt securities is 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,

Table of Contents

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 or the security matures. Changes in the credit loss component of credit-impaired debt securities were:

	June 30, 2009	
(Dollars in thousands)	**Quarter ended**	**Six months ended**
Balance, beginning of period	$ 1,688	$
Additions:		
Initial credit impairments	975	2,663
Subsequent credit impairments	142	142
Reductions:		
Securities sold		
Due to change in intent to sell or requirement to sell		
Increases in expected cash flows		
Balance, end of period	$ 2,805	$ 2,805

Other-Than-Temporary Impairment

The following table presents details of other-than-temporary impairment related to securities, including equity securities carried at cost, for the quarter and six months ended June 30, 2009.

	June 30, 2009	
(Dollars in thousands)	**Quarter ended**	**Six months ended**
Other-than-temporary impairment charges (included in earnings):		
Debt securities:		
Pooled trust preferred securities	$ 975	$ 975
Individual issuer trust preferred securities	142	1,830
Total debt securities	1,117	2,805
Cost-method investments	665	1,980
Total other-than-temporary impairment charges	$ 1,782	$ 4,785
Other-than-temporary impairment on debt securities:		
Recorded as part of gross realized losses:		
Credit-related	$ 1,117	$ 2,805
Securities with intent to sell		
Recorded directly to other comprehensive income for non-credit related impairment	1,635	1,635
Total other-than-temporary impairment on debt securities	$ 2,752	$ 4,440

Securities that were determined to be credit impaired during the current quarter as opposed to prior quarters, in general have experienced further degradation in cash flows primarily due to higher forecasted defaults for the underlying collateral.

Realized Gains and Losses

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

	Quarter ended June 30		Six months ended June 30	
(Dollars in thousands)	**2009**	**2008**	**2009**	**2008**
Gross realized gains	$ 1,057	$ 52	$ 1,937	$ 95
Gross realized losses	(1,815)		(4,818)	
Net realized gains (losses)	$ (758)	$ 52	$ (2,881)	$ 95

NOTE 5: FAIR VALUE DISCLOSURES

Fair value is defined by SFAS No. 157 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company s assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs 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, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The Company s assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy in accordance with SFAS No. 157.

Securities Securities available-for-sale are recorded at fair value on a recurring basis. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly-liquid government securities such as U.S. Treasuries and exchange-traded equity securities.

When instruments are traded in secondary markets and quoted market prices are not available, the Company generally relies on prices obtained from independent vendors. Vendors compile prices from various sources and often apply matrix pricing for similar securities when no price is observable. Securities measured with these valuation techniques are generally classified within Level 2 of the valuation hierarchy and often involve using quoted market prices for similar securities, pricing models or discounted cash flow analyses using inputs observable in the market where available. Examples include U.S. government agency securities and residential mortgage-backed securities.

Security fair value measurements using significant inputs that are unobservable in the market due to limited activity or a less liquid market are classified within Level 3 of the valuation hierarchy. Such measurements include securities valued using models or a combination of valuation techniques such as weighting of models and vendor or broker pricing, where the unobservable inputs are significant to the overall fair value measurement. Securities classified as Level 3 include pooled and individual issuer trust preferred securities.

Loans held for sale Loans held for sale are carried at the lower of cost or estimated fair value and are subjected to nonrecurring fair value adjustments. Estimated fair value is determined on the basis of the current market value of similar loans. All of the Company s loans held for sale are classified within Level 2 of the valuation hierarchy.

Loans, net Loans considered impaired under SFAS No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS No. 118, Accounting by Creditors for Impairment of a Loan Income Recognition and Disclosure, are loans for which, based on current information and events, it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are subject to nonrecurring fair value adjustments to reflect (1) partial write-downs that are based on the observable market price or current appraised value of the collateral, or (2) the full charge-off of the loan carrying value. All of the Company s impaired loans are classified within Level 3 of the valuation hierarchy.

Other real estate Other real estate, consisting of properties obtained through foreclosure or in satisfaction of loans, are adjusted to 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 value is generally determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs. All of the Company s other real estate is classified within Level 3 of the valuation hierarchy.

Table of Contents

Other assets The Company has certain financial assets carried at fair value on a recurring basis, including interest rate swap agreements. The carrying amount of interest rate swap agreements is based on information obtained from a third party bank. These swaps qualify as derivatives, but are not designated as hedging instruments. The Company had no derivative contracts to assist in managing interest rate sensitivity at June 30, 2009 and December 31, 2008, respectively. The Company classified these assets within Level 2 of the valuation hierarchy.

Other liabilities The Company has certain financial liabilities carried at fair value on a recurring basis, including interest rate swap agreements. The carrying amount of interest rate swap agreements is based on information obtained from a third party bank. These swaps qualify as derivatives, but are not designated as hedging instruments. The Company had no derivative contracts to assist in managing interest rate sensitivity at June 30, 2009 and December 31, 2008, respectively. The Company classified these assets within Level 2 of the valuation hierarchy.

Assets and liabilities measured at fair value on a recurring basis

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of June 30, 2009 and December 31, 2008, respectively, by caption, on the consolidated balance sheets and by SFAS No. 157 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)
June 30, 2009:				
Securities available-for-sale	$ 349,472		347,790	1,682
Other assets	1,075		1,075	
Total assets at fair value	$ 350,547		348,865	1,682
Other liabilities	$ 1,075		1,075	
Total liabilities at fair value	$ 1,075		1,075	
December 31, 2008:				
Securities available-for-sale	$ 302,656		293,951	8,705
Other assets	1,580		1,580	
Total assets at fair value	$ 304,236		295,531	8,705
Other liabilities	$ 1,580		1,580	
Total liabilities at fair value	$ 1,580		1,580	

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements for financial assets recognized in the accompanying condensed consolidated balance sheets using Level 3 inputs:

(Dollars in thousands)	Six months ended June 30, 2009

Beginning balance	$	8,705
Total realized and unrealized gains and (losses):		
Included in net earnings		(3,328)
Included in other comprehensive income		(1,082)
Purchases, issuances and settlements		
Transfers in and/or (out) of Level 3		(2,613)
Ending balance	$	1,682

Table of Contents

Assets and liabilities measured at fair value on a nonrecurring basis

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of June 30, 2009 and December 31, 2008, respectively, by caption, on the consolidated balance sheets and by SFAS No. 157 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)
June 30, 2009:				
Loans held for sale	$ 6,162		6,162	
Loans, net [1]	2,884			2,884
Other real estate	5,149			5,149
Total assets at fair value	$ 14,195		6,162	8,033
December 31, 2008:				
Loans held for sale	$ 3,819		3,819	
Loans, net [1]	4,329			4,329
Other real estate	324			324
Total assets at fair value	$ 8,472		3,819	4,653

[1] Loans considered impaired under SFAS No. 114.

NOTE 6: FAIR VALUE OF FINANCIAL INSTRUMENTS

SFAS No. 107, Disclosures about Fair Value of 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 and other valuation techniques. 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. SFAS No. 107 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:

Cash and cash equivalents

Due to their short-term nature, the carrying amounts reported in the balance sheet are assumed to approximate fair value for these assets. For purposes of disclosure, cash equivalents include federal funds sold and other short-term investments.

Securities

Fair value measurement is based upon quoted prices if available. If quoted market prices are not available, estimated fair values are based on quoted market prices of comparable instruments. See Note 5 for additional disclosure related to fair value measurements for securities.

Loans held for sale

Loans held for sale are carried at the lower of cost or estimated fair value and are subjected to nonrecurring fair value adjustments. Estimated fair value is determined on the basis of the current market value of similar loans.

Loans, net

The fair value of loans is calculated using discounted cash flows. The discount rates used to determine the present value of the loan portfolio are estimated market discount rates that reflect the credit and interest rate risk inherent in

Table of Contents

the loan portfolio. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by SFAS No. 157. The estimated maturities are based on the Company s historical experience with repayments adjusted to estimate the effect of current market conditions. The carrying amount of accrued interest approximates its fair value.

Deposits

Under SFAS No. 107, the fair value of deposits with no stated maturity, such as noninterest bearing demand deposits, interest bearing demand deposits and savings and certain types of money market accounts, is equal to the amount payable on demand at the reporting date (i.e., their carrying amount). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using discounted cash flows. The discount rates used are based on estimated market rates for deposits of similar remaining maturities.

Short-term borrowings

The fair values of federal funds purchased, securities sold under agreements to repurchase, and other short term borrowings approximate their carrying value.

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.

Derivative Instruments

The Company enters into interest rate swaps to meet the financing, interest rate and equity risk management needs of its customers. The carrying amounts of these derivative instruments represent their fair value. Generally, the fair value of these instruments is based on an observable market price.

Off-balance sheet Instruments

The fair values of the Company s off-balance-sheet financial instruments are based on fees charged to enter into similar agreements. However, commitments to extend credit do not represent a significant value to the Company until such commitments are funded. The Company has determined that the estimated fair value of commitments to extend credit approximates the carrying amount and is immaterial to the financial statements.

The carrying value and related estimated fair value of the Company s financial instruments at June 30, 2009 and December 31, 2008 are presented below.

	June 30, 2009		**December 31, 2008**	
(Dollars in thousands)	**Carrying amount**	**Estimated fair value**	**Carrying amount**	**Estimated fair value**
Financial Assets:				
Cash and cash equivalents	$ 30,857	$ 30,857	$ 36,433	$ 36,433
Securities	349,472	349,472	302,656	302,656
Loans held for sale	6,126	6,126	3,819	3,819
Loans, net	368,575	369,328	364,764	366,994
Derivative Assets	1,075	1,075	1,580	1,580
Financial Liabilities:				
Deposits	$ 616,442	$ 619,976	$ 550,843	$ 557,452
Short-term borrowings	9,541	9,541	10,910	10,910
Long-term debt	118,358	123,835	123,368	134,110

Derivative Liabilities	1,075	1,075	1,580	1,580

Table of Contents

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 hedges, 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 instruments to meet customer needs, 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 June 30, 2009 the Company had no derivative contracts to assist in managing interest rate sensitivity.

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

A summary of the Company s interest rate swaps as of and for the six months ended June 30, 2009 is presented below.

		Other Assets	Other Liabilities	Other noninterest income
(Dollars in thousands)	**Notional**	**Estimated Fair Value**	**Estimated Fair Value**	**Gains (Losses)**
Interest rate swap agreements:				
Pay fixed / receive variable	$ 6,592	$	$ 1,075	$ 505
Pay variable / receive fixed	6,592	1,075		(505)
Total interest rate swap agreements	$ 13,184	$ 1,075	$ 1,075	$

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 consolidated financial statements and related notes for the quarter and six months ended June 30, 2009 and 2008, as well as the information contained in our annual report on Form 10-K for the year ended December 31, 2008 and our quarterly report on Form 10-Q for the quarter ended March 31, 2009.

Certain of the statements made herein under the caption MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, 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, belie contemplate, expect, seek, estimate, evaluate, continue, plan, point to, project, predict, could, intend, target, potenti and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation:

- future economic, business and market conditions; domestic and foreign;
- government monetary and fiscal policies;
- legislative and regulatory changes, including changes in banking, securities and tax laws and regulations, and their application by governmental authorities;
- 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;
- credit risks of borrowers;
- changes in the prices, values, sales volumes and liquidity of residential and commercial real estate, as well as securities;
- the failure of assumptions underlying the establishment of reserves for possible loan losses and other estimates;
- the effects of competition from a wide variety of local, regional, national and other providers of financial, investment, and insurance services;

the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of effecting 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 the availability and cost of credit and capital in the financial markets;

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

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

Table of Contents

conditions and economic confidence; 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, 2008 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

Auburn National Bancorporation, Inc. (the Company) is a one-bank holding company established in 1984, and incorporated under the laws of the State of Delaware. AuburnBank (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 in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, 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. Mortgage loan offices are located in Phenix City, Valley, and Mountain Brook, Alabama.

Summary of Results of Operations

	Quarter ended June 30		Six months ended June 30	
(Dollars in thousands, except per share amounts)	**2009**	**2008**	**2009**	**2008**
Net interest income (a)	$ 4,923	$ 4,813	$ 9,807	$ 9,455
Less: tax-equivalent adjustment	404	341	763	662
Net interest income (GAAP)	4,519	4,472	9,044	8,793
Noninterest income	1,263	1,316	1,174	2,689
Total revenue	5,782	5,788	10,218	11,482
Provision for loan losses	700	180	1,250	240
Noninterest expense	3,924	3,105	7,477	6,254
Income tax expense	226	636	313	1,270
Net earnings	$ 932	$ 1,867	$ 1,178	$ 3,718
Basic and diluted earnings per share	$ 0.25	$ 0.51	$ 0.32	$ 1.01

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

Financial Summary

The Company s net earnings were $1.2 million for the first six months of 2009 compared to $3.7 million for the first six months of 2008. Basic and diluted earnings per share were $0.32 per share for the first six months of 2009 compared to $1.01 per share for the first six months of 2008.

Net interest income (tax-equivalent) was approximately $9.8 million for the first six months of 2009, compared to $9.5 million from the first six months of 2008. Average loans were up to $373.6 million in the first six months of 2009, an increase of $38.9 million, or 12%, from the first six months of 2008. Average deposits were up to $596.2 million in the first six months of 2009, an increase of $76.0 million, or 15%, from the first six months of 2008.

Although the Company s annualized net charge-off ratio increased to 0.54% in the first six months of 2009 from 0.18% in the first six months of 2008, the Company s credit quality continues to compare favorably to industry peers. Nonperforming assets increased on a linked-quarter basis. Nonperforming assets were 1.53% of total loans and foreclosed properties at June 30, 2009, compared to 1.24% at March 31, 2009. The provision for loan losses increased to $1,250,000 in the first six months of 2009 compared with $240,000 in the first six months of 2008. The increase in provision for loan losses reflects the credit risk associated with loan portfolio growth and an increase in net charge-offs.

Noninterest income decreased by approximately $1.5 million in the first six months of 2009 compared to the same period in 2008. The primary reason for the decrease was a net securities loss of $2.9 million, offset by an increase in mortgage lending income of $1.7 million.

Primarily as a result of the FDIC assessments and salaries and benefits expense, noninterest expense for the first six months of 2009 increased 20% from approximately $6.3 million in the first six months of 2008.

In the first six months of 2009, the Company paid cash dividends of $1.4 million, or $0.38 per share. The Company s balance sheet remains strong and well capitalized under regulatory guidelines with a Tier 1 capital ratio of 13.81% and a leverage ratio of 7.89% at June 30, 2009.

In the second quarter of 2009, net earnings were $0.9 million, or $0.25 per share, compared to $1.9 million, or $0.51 per share, for the second quarter of 2008. Total revenue was $5.8 million for the second quarter of 2009 and 2008, respectively. The provision for loan losses increased to $700 thousand in the second quarter of 2009 compared with $180 thousand in the second quarter of 2008. The increase in the provision for loan losses reflects the credit risk associated with loan portfolio growth and an increase in net charge-offs. In addition, noninterest expense was approximately $3.9 million in the second quarter of 2009, including the impact of a $0.4 million special FDIC assessment.

CRITICAL ACCOUNTING POLICIES

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles and 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 and fair value measurements, were critical to the determination of our financial position and results of operations. Critical accounting policies are defined as policies which are important to the portrayal of the Company s financial condition and results of operations, and that require management s most difficult, subjective or complex judgments. These estimates and judgments involve significant uncertainties, and are susceptible to change. If different conditions exist or occur - depending upon the magnitude of the changes; then our actual financial condition and financial results could differ significantly. For a more detailed discussion on these critical accounting policies, see CRITICAL ACCOUNTING POLICIES on pages 30-31 of the Company s annual report on Form 10-K for the year ended December 31, 2008.

RESULTS OF OPERATIONS

Average Balance Sheet and Interest Rates

	Six months ended June 30			
	2009		2008	
(Dollars in thousands)	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
Loans and loans held for sale	$ 378,365	5.74%	$ 337,340	6.79%
Securities - taxable	275,937	4.57%	262,943	5.07%
Securities - tax-exempt	69,906	6.47%	61,214	6.41%
Total securities	345,843	4.95%	324,157	5.32%
Federal funds sold	12,607	0.22%	4,825	2.21%
Interest bearing bank deposits	1,423	0.14%	605	3.66%
Total interest-earning assets	$ 738,238	5.27%	$ 666,927	6.04%
Deposits:				
NOW	$ 89,290	1.02%	$ 75,944	2.13%
Savings and money market	92,121	1.21%	115,918	1.97%
Certificates of deposits less than $100,000	145,607	3.16%	96,966	4.85%
Certificates of deposits and other time deposits of $100,000 or more	191,954	3.93%	160,108	4.54%
Total interest-bearing deposits	518,972	2.73%	448,936	3.54%
Short-term borrowings	12,277	0.51%	11,902	2.36%
Long-term debt	122,174	3.99%	119,979	4.24%
Total interest-bearing liabilities	$ 653,423	2.93%	$ 580,817	3.66%

Net interest income and margin	$	9,807	2.68%	$	9,455	2.86%

Net Interest Income and Margin

Tax-equivalent net interest income increased 4% in the first six months of 2009 from the first six months of 2008 as a result

24

Table of Contents

of balance sheet growth. Net interest margin was 2.68% for the first six months of 2009, compared to 2.86% for the first six months of 2008.

The tax-equivalent yield on total interest earning assets decreased 77 basis points in the first six months of 2009 from the first six months of 2008, to 5.27%. This decrease was comprised of a 105 basis point decrease in the yield on loans and loans held for sale to 5.74% and a 37 basis point decrease in the tax-equivalent yield on total securities to 4.95%.

The cost of total interest-bearing liabilities decreased 73 basis points in the first six months of 2009 from the first six months of 2008, to 2.93%. This decrease was comprised of an 81 basis point decrease in the cost of total interest-bearing deposits to 2.73%, a 185 basis point decrease in the cost of short-term borrowings to 0.51%, and a 25 basis point decrease in the cost of long-term debt to 3.99%. The average federal funds rate during the first six months of 2009 was 245 basis points lower than the average for the same period in 2008.

Noninterest Income

	Quarter ended June 30		**Six months ended June 30**	
(Dollars in thousands)	**2009**	**2008**	**2009**	**2008**
Service charges on deposit accounts	$ 302	$ 297	$ 605	$ 608
Mortgage lending income	1,310	426	2,640	896
Bank-owned life insurance	110	116	208	238
Securities gains, net	(758)	52	(2,881)	95
Other	299	425	602	852
Total noninterest income	$ 1,263	$ 1,316	$ 1,174	$ 2,689

The major components of noninterest income are service charges on deposit accounts, mortgage lending income, income from bank-owned life insurance, securities gains (losses), net, and other noninterest income.

Noninterest income decreased by approximately $1.5 million in the first six months of 2009 compared to the same period in 2008. The primary reason for the decrease was a net securities loss of $2.9 million, offset by an increase in mortgage lending income of $1.7 million. The net loss on securities was attributable to other-than-temporary impairment charges of $4.8 million, offset by $1.9 million of gross gains on the sale of securities. Mortgage lending income typically fluctuates as mortgage interest rates change and is primarily attributable to increased volume in the origination and sale of new mortgage loans.

Noninterest income decreased 4%, or $53 thousand, in the second quarter of 2009 compared to the same period in 2008 due to the same factors described above.

Noninterest Expense

	Quarter ended June 30		**Six months ended June 30**	
(Dollars in thousands)	**2009**	**2008**	**2009**	**2008**
Salaries and benefits	$ 1,974	$ 1,721	$ 4,023	$ 3,574
Net occupancy and equipment	395	327	739	633
Professional fees	174	158	335	316
Other	1,381	899	2,380	1,731
Total noninterest expense	$ 3,924	$ 3,105	$ 7,477	$ 6,254

The major components of noninterest expense are salaries and benefits, net occupancy and equipment, professional fees, and other noninterest expense.

Noninterest expense was approximately $7.5 million in the first six months of 2009, including the impact of a $0.4 million special FDIC assessment. This assessment was in addition to the increase in the Company s recurring FDIC insurance premium that began in the first quarter of 2009. Primarily as a result of the FDIC assessments and salaries and benefits expense, noninterest expense for the first six months of 2009 increased 20% from approximately $6.3 million in the first six months of 2008. Salaries and benefits expense increased primarily due to commissions paid to our mortgage originators as a result of increased origination volume.

Noninterest expense increased 26%, or $0.8 million, in the second quarter of 2009 compared to the same period in 2008

Table of Contents

due to the same factors described above.

Income Tax Expense

The Company recognized income tax expense of $313 thousand in the first six months of 2009, compared to income tax expense of $1.3 million in the first six months of 2008. The decrease in income tax expense is largely due to a decrease in pre-tax earnings during the first six months of 2009. The Company s effective tax rate for the first six months of 2009 was 20.99%, compared to an effective tax rate of 25.46% for the first six months of 2008. The Company s effective tax rate for the first six months of 2009 was also impacted by the recognition of a valuation allowance related to a capital loss for income tax purposes on the Company s investment in the common stock of Silverton Financial Services, Inc, the parent company of Silverton Bank, which failed. The valuation allowance reduced the deferred tax asset created by the write-off of the investment s carrying value to an amount management believes will more-likely-than-not be realized.

BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale were $349.5 million and $302.7 million as of June 30, 2009 and December 31, 2008, respectively. The net unrealized loss on securities available-for-sale was $5.2 million at June 30, 2009 compared to a net unrealized gain of $1.0 million at December 31, 2008. Decreases in the fair value of securities available-for-sale during the first six months of 2009 were primarily driven by changes in interest rates and changes in the values of trust preferred securities.

The average yields earned on total securities were 4.95% in the first six months of 2009 and 5.32% in the first six months of 2008.

Loans

	2009		2008		
	Second	First	Fourth	Third	Second
(In thousands)	Quarter[1]	Quarter	Quarter	Quarter	Quarter
Commercial, financial and agricultural	$ 52,106	$ 52,147	$ 53,542	$ 50,743	$ 51,380
Leases - commercial	291	316	341	374	431
Construction and land development	53,304	70,828	67,420	67,520	65,792
Real estate - mortgage:					
Commercial	147,843	137,253	132,818	123,367	115,746
Residential	108,576	103,004	102,835	100,540	98,752
Consumer installment	11,330	10,887	12,463	12,663	13,491
Total loans	373,450	374,435	369,419	355,207	345,592
Less: unearned income	(229)	(250)	(257)	(299)	(284)
Loans, net of unearned income	$ 373,221	$ 374,185	$ 369,162	$ 354,908	$ 345,308

[1] In order for the loan categories presented above and in Table 6 Loan Portfolio Composition to be consistent with the loan categories presented in Table 8 Allocation of Allowance for Loan Losses , the Company reclassified certain loan amounts reported in prior periods to conform to the current-period presentation.

Total loans, net of unearned income, were $373.2 million as of June 30, 2009, an increase of $4.1 million, or 1%, from $369.2 million at December 31, 2008. The increase in loans, net of unearned income, is primarily due to growth in commercial real estate mortgage loans and residential real estate mortgage loans of $15.0 million and $5.7 million, respectively, offset by a decrease in construction and land development loans of $14.0 million.

Four loan categories represented the majority of the loan portfolio as of June 30, 2009. Commercial real estate mortgage loans represented 40%, residential real estate mortgage loans represented 29%, construction and land development loans represented 14% and commercial, financial and agricultural loans represented 14% of the Company s total loans at June 30, 2009.

Table of Contents

Purchased loan participations included in the Company s loan portfolio were approximately $6.8 million and $10.7 million as of June 30, 2009 and December 31, 2008, respectively. All purchased loan participations are underwritten by the Company and 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 as described in CRITICAL ACCOUNTING POLICIES on pages 30-31 of the Company s annual report on Form 10-K for the year ended December 31, 2008.

The average yield earned on loans and loans held for sale was 5.74% in the first six months of 2009 and 6.79% in the first six months of 2008.

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level that management deems appropriate to adequately cover the probable losses in the loan portfolio. As of June 30, 2009 and December 31, 2008, respectively, the allowance for loan losses was $4.6 million and $4.4 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 on pages 30 31 of the Company s annual report on Form 10-K for the year ended December 31, 2008.

A summary of the changes in the allowance for loan losses during the second quarter of 2009 and the previous four quarters are presented below.

	2009		2008		
	Second	First	Fourth	Third	Second
(Dollars in thousands)	Quarter	Quarter	Quarter	Quarter	Quarter
Balance at beginning of period	$ 4,532	$ 4,398	$ 4,226	$ 4,049	$ 4,074
Charge-offs	(626)	(441)	(88)	(238)	(240)
Recoveries	40	25	10	35	35
Net (charge-offs) recoveries	(586)	(416)	(78)	(203)	(205)
Provision for loan losses	700	550	250	380	180
Ending balance	$ 4,646	$ 4,532	$ 4,398	$ 4,226	$ 4,049

As noted in our critical accounting policies, management assesses the adequacy of the allowance prior to the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The level of the allowance is based upon management s evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates 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 1.24% at June 30, 2009, compared to 1.19% at December 31, 2008. 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.

At June 30, 2009 and December 31, 2008, the Company s recorded investment in loans considered impaired was $2.9 and $4.3 million, respectively. No specific allowance was established for impaired loans at June 30, 2009 and December 31, 2008, respectively, because the fair value of the collateral less estimated selling costs was greater than the Company s recorded investment in the impaired loans.

In addition, our regulators, as an integral part of their examination process, will periodically review the Company s allowance for loan losses, and may require the Company to make additional provisions to the allowance for loan losses based on their judgment about information available to them at the time of their examinations.

Provision for Loan Losses

The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management s evaluation, should be adequate to provide coverage for the probable losses on outstanding loans. The

Table of Contents

provision for loan losses amounted to $1,250,000 and $240,000 for the six months ended June 30, 2009 and 2008, respectively.

Based upon its evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at June 30, 2009. Increased charge-offs in the first six months of 2009 compared to the first six months of 2008 and loan portfolio growth were the primary reasons for the increased provision expense.

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. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management and are reviewed from time to time by our regulators, they are necessarily approximate. There exist factors beyond our control, such as general economic conditions both locally and nationally, which may negatively impact, materially, the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

Nonperforming Assets

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, a general downturn in the economy which could affect employment rates in our market areas, general real estate market conditions, including values, nondistressed sales volumes, availability and costs of credit in the markets, generally, interest rate fluctuations, deteriorated or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and possible violations of laws and regulations.

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 June 30, 2009, the Company had $645 thousand in loans on nonaccrual, compared to $4.4 million at December 31, 2008. The primary reason for the decrease in loans on nonaccrual relates to a loan participation purchased from Silverton Bank. Subsequent to foreclosure, the Company transferred the carrying balance of its investment in the purchased participation loan, approximately $4.3 million, to other real estate.

The Company owned $5.1 million in other real estate, which we had acquired from borrowers at June 30, 2009, compared to $324 thousand at December 31, 2008. The increase in other real estate primarily relates to the corresponding decrease in nonaccrual loans described above.

The Company had $28 thousand in loans 90 days past due and still accruing interest at June 30, 2009 compared to $104 thousand at December 31, 2008. At June 30, 2009 and at December 31, 2008, no loans were deemed to be restructured loans.

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

(In thousands)	**2009** **Second Quarter**	**First Quarter**	**2008** **Fourth Quarter**	**Third Quarter**	**Second Quarter**
Nonperforming assets:					
Nonaccrual loans	$ 645	4,537	4,431	4,721	4,926
Other nonperforming assets (primarily other real estate owned)	5,149	113	324	594	422
Total nonperforming assets	$ 5,794	4,650	4,755	5,315	5,348
as a % of loans and foreclosed properties	1.53%	1.24	1.29	1.50	1.55
as a % of total assets	0.72%	0.58	0.64	0.72	0.73
Nonaccrual loans as a % of loans	0.17%	1.21	1.20	1.33	1.43
Accruing loans 90 days or more past due	$ 28	56	104		

Potential problem assets, which are not included in nonperforming assets, amounted to $11.8 million, or 3.2% of total loans outstanding, net of unearned income at June 30, 2009, compared to $3.9 million, or 1.1% of total loans outstanding, net of unearned income at December 31, 2008. Potential problem assets represent those assets with a well-defined weakness and

Table of Contents

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. Continued weakness in the economy could adversely affect the Company s volume of potential problem and nonperforming assets.

Deposits

Total deposits were $616.4 million and $550.8 million at June 30, 2009 and December 31, 2008, respectively. NOW accounts increased $15.4 million, or 29%, savings and money market accounts increased $10.0 million, or 13%, CDs and other time deposits less than $100,000 increased $11.9 million, or 12%, and CDs and other time deposits of $100,000 or more increased $22.8 million, or 18%, respectively, from December 31, 2008.

The average rate paid on total interest-bearing deposits was 2.73% in the first six months of 2009 and 3.54% in the first six months of 2008, which reflects declines in market interest rates.

Noninterest bearing deposits were 13% and 14% of total deposits at June 30, 2009 and December 31, 2008, respectively.

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 $30.0 million with none outstanding at June 30, 2009, compared to $44.0 million with none outstanding at December 31, 2008. The decrease in federal funds lines is primarily due to the discontinuance of a $16.0 million federal funds line provided by Silverton Bank, which failed. Since June 30, 2009, the Company has increased the amount of federal funds lines available to $34.0 million and is in the process of obtaining additional federal funds lines. Securities sold under agreements to repurchase totaled $9.5 million at June 30, 2009, compared to $10.9 million at December 31, 2008.

The average rate paid on short-term borrowings was 0.51% in the first six months of 2009 and 2.36% in the first six months of 2008.

Long-term debt included 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 $86.1 and 91.2 million in long-term FHLB advances at June 30, 2009 and December 31, 2008, respectively. The Bank had $25.0 million in securities sold under agreements to repurchase with an original maturity greater than one year, and the Company had $7.2 million in junior subordinated debentures related to trust preferred securities outstanding at June 30, 2009 and December 31, 2008, respectively.

The average rate paid on long-term debt was 3.99% in the first six months of 2009 and 4.24% in the first six months of 2008.

CAPITAL ADEQUACY

The Company s consolidated stockholders equity balances were $52.9 million and $57.1 million as of June 30, 2009 and December 31, 2008, respectively. The decrease from December 31, 2008 is primarily driven by an other comprehensive loss due to the change in unrealized gains (losses) on securities available-for-sale of $3.9 million and cash dividends paid of approximately $1.4 million, offset by net earnings of $1.2 million.

The Company s Tier 1 leverage ratio was 7.89%, Tier 1 risk-based capital ratio was 13.81% and Total risk-based capital ratio was 14.82% at June 30, 2009. These ratios exceed the minimum regulatory capital percentages of 4.0% for Tier 1 leverage ratio, 4.0% for Tier 1 risk-based capital ratio and 8.0% for Total risk-based capital ratio. Based on current regulatory standards, the Company is classified as well capitalized.

MARKET AND LIQUIDITY RISK MANAGEMENT

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

29

Table of Contents

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 are in compliance with our current guidelines at June 30, 2009.

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 30 percent. The results of our current economic value of equity model would indicate that we are in compliance with our current guidelines at June 30, 2009.

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 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 June 30, 2009 and December 31, 2008, 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 have 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 includes dividends received from the Bank, and secondarily proceeds from the issuance of common stock or other securities. Primary uses of funds for the Company include dividends paid to shareholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. The junior subordinated debentures are presented as long-term debt in the Consolidated Balance Sheets and the related trust preferred securities are includible in Tier 1 Capital for regulatory capital purposes.

30

Table of Contents

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. As of June 30, 2009, the Bank had an available line of credit with the FHLB totaling $239.5 million with $86.1 million outstanding. As of June 30, 2009, the Bank also had $30.0 million of federal funds lines with none outstanding. Since June 30, 2009, the Company has increased the amount of federal funds lines available to $34.0 million and is in the process of obtaining additional federal funds lines. 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

At June 30, 2009, the Bank had outstanding standby letters of credit of $8.2 million and unfunded loan commitments outstanding of $42.4 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or draw on its available credit facilities.

Effects of Inflation and Changing Prices

Virtually all of the assets and liabilities of the Company are monetary in nature. As a result, interest rates have a more significant effect on the Company s performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or with the same magnitude as the price of goods and services because such prices are affected by inflation. In the current interest rate environment, liquidity and the maturity structure of the Company s assets and liabilities are critical to the maintenance of desired performance levels.

RECENT ACCOUNTING PRONOUNCEMENTS

In the first quarter of 2009, the Company adopted the following new accounting pronouncements:

- Statement of Financial Accounting Standards (SFAS) No. 141R (revised 2007), Business Combinations ;
- SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 ;
- Statement of Financial Accounting Standards (SFAS) No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 ;
- FASB Staff Position (FSP) FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly ; and
- FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments .

In the second quarter of 2009, the Company adopted the following new accounting pronouncements:

- FSP FAS 107-1 and APB Opinion 28-1, Interim Disclosures about Fair Value of Financial Instruments ; and
- SFAS No. 165, Subsequent Events .

In addition, the following accounting pronouncements were issued by the FASB, but are not yet effective:

- SFAS No. 166, Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140 ;
- SFAS No. 167, Amendments to FASB Interpretation No. 46(R) ; and
- SFAS No. 168, The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 .

Each of these pronouncements is described in more detail below.

SFAS No. 141R clarifies the definitions of both a business combination and a business. All business combinations will be accounted for under the acquisition method (previously referred to as the purchase method). This standard defines the

31

acquisition date as the only relevant date for recognition and measurement of the fair value of consideration paid. SFAS No. 141R requires the acquirer to expense all acquisition related costs. SFAS No. 141R will also require acquired loans to be recorded net of the allowance for loan losses on the date of acquisition. SFAS No. 141R defines the measurement period as the time after the acquisition date during which the acquirer may make adjustments to the provisional amounts recognized at the acquisition date. This period cannot exceed one year, and any subsequent adjustments made to provisional amounts are done retrospectively and restate prior period data. Adoption of SFAS No. 141R in the first quarter of 2009 did not have a significant impact on the consolidated financial statements of the Company.

SFAS No. 160 requires noncontrolling interests to be treated as a separate component of equity, not as a liability or other item outside of equity. Disclosure requirements include net income and comprehensive income to be displayed for both the controlling and noncontrolling interests and a separate schedule that shows the effects of any transactions with the noncontrolling interests on the equity attributable to the controlling interest. Adoption of SFAS No. 160 in the first quarter of 209 did not have a significant impact on the consolidated financial statements of the Company.

SFAS No. 161, which amends FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, requires companies with derivative instruments to disclose information about how and why a company uses derivative instruments, how derivative instruments and related hedge items are accounted for under Statement 133, and how derivative instruments and related hedged items affect a company s financial position, financial performance, and cash flows. The required disclosures include the fair value of the derivative instruments and their gains or losses in tabular format, information about credit-risk-related contingent features in derivative agreements, counterparty credit risk, and the company s strategies and objectives for using derivative instruments. The Statement expands the current disclosure framework in SFAS No. 133. Adoption of SFAS No. 161 in the first quarter of 2009 impacted disclosures only and did not have a significant impact on the consolidated financial statements of the Company.

FSP FAS 157-4 provides factors that an entity should consider when determining whether a market for an asset is not active. If after evaluating the relevant factors, the evidence indicates that a market is not active, FSP FAS 157-4 provides an additional list of factors that an entity must consider when determining whether events and circumstances indicate that a transaction which occurred in such inactive market is orderly. FSP FAS 157-4 requires that entities place more weight on observable transactions determined to be orderly and less weight on transactions for which there is insufficient information to determine whether the transaction is orderly when determining the fair value of an asset or liability under Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). FSP FAS 157-4 requires enhanced disclosures, including disclosure of a change in valuation technique which results from its application and disclosure of fair value measurements for debt and equity securities by major security types. The provisions of this FSP were effective in the second quarter of 2009; however, as permitted under the pronouncement, the Company early adopted in the first quarter of 2009 and the effects of adoption were not significant.

FSP FAS 115-2 replaces the intent and ability to hold to recovery indicator of other-than-temporary impairment in FASB Staff Position No. FAS 115-1 and 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1) for debt securities. FSP FAS 115-2 specifies that for a debt security not to be considered other-than-temporarily impaired, an entity s management must assert that it does not intend to sell the security and that it is not more-likely-than-not that the entity will have to sell the security prior to recovery of its cost basis. FSP FAS 115-2 requires that for impaired held-to-maturity and available-for-sale debt securities that an entity does not intend to sell and that it is not more-likely-than-not that it will have to sell prior to recovery but for which credit losses exist, the other-than-temporary impairment should be separated between the total impairment related to credit losses, which should be recognized in current earnings, and the amount of impairment related to all other factors, which should be recognized in other comprehensive income. FSP FAS 115-2 discusses the proper interaction of its guidance with other authoritative guidance, including FSP FAS 115-1, which provide additional factors that must be considered in an other-than-temporary impairment analysis. FSP FAS 115-2 also provides that in periods in which other-than-temporary impairments are recognized, the total impairment must be presented in the investor s income statement with an offset for the amount of total impairment that is recognized in other comprehensive income. FSP FAS 115-2 requires additional disclosures including a rollforward of amounts recognized in earnings for debt securities for which an other-than-temporary impairment has been recognized and the noncredit portion of the other-than-temporary impairment that has been recognized in other comprehensive income. The provisions of this FSP were effective in the second quarter of 2009; however, as permitted under the pronouncement, the Company early adopted in the first quarter of 2009. No adjustment was made to the beginning balance of retained earnings. For more information on the effects of adoption, see Note 4 for additional disclosures included in accordance with FSP FAS 115-2 and 124-2.

FSP FAS 107-1 and APB Opinion 28-1, Interim Disclosures about Fair Value of Financial Instruments, requires disclosures about fair value of financial instruments in interim reporting periods of publicly traded companies that were previously only required to be disclosed in annual financial statements. The FSP was effective for interim and annual

periods ending after June 15, 2009. Accordingly, the Company adopted this FSP in the second quarter of 2009. The adoption of FSP FAS 107-1 has impacted disclosures only and has not had an impact on the financial position or results of operations of the Company. See Note 6 for additional disclosures included in accordance with FSP FAS 107-1.

SFAS No. 165, Subsequent Events , establishes general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS No. 165 was effective for periods ending after June 15, 2009. Accordingly, the Company adopted this standard in the second quarter of 2009 and has evaluated any subsequent events through the date of this filing. The Company does not believe there are any material subsequent events which would require further disclosure. Adoption of SFAS No. 165 did not have a significant impact on the consolidated financial statements of the Company. See Note 1 (Summary of Significant Accounting Policies) in this report for the Company s discussion of subsequent events.

In June 2009, SFAS No. 166, Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140, was issued. SFAS No. 166 eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures in order to enhance information reported to users of financial statements by providing greater transparency about transfers of financial assets, including securitization transactions, and an entity s continuing involvement in and exposure to the risks related to transferred financial assets. SFAS No. 166 is effective for fiscal years beginning after November 15, 2009. The Company is currently evaluating this Statement and its effect on the consolidated financial statements of the Company.

In June 2009, SFAS No. 167, Amendments to FASB Interpretation No. 46(R), was issued. SFAS No. 167 amends certain requirements of FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. SFAS No. 167 is effective for fiscal years beginning after November 15, 2009. The Company is currently evaluating this Statement and its effect on the consolidated financial statements of the Company.

In June 2009, SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, was issued. SFAS No. 168 replaces SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles, and establishes the FASB Accounting Standards Codification (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). Rules and interpretive releases of the Securities and Exchange Committee (the SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. SFAS 168 is effective for interim and annual periods ending after September 15, 2009. SFAS No. 168 will change our disclosures as references to existing accounting literature will be updated to reflect the Codification. However, the adoption of FAS 168 will not affect our consolidated financial statements.

Table of Contents

Table 1 - Explanation of Non-GAAP Financial Measures

This quarterly report on Form 10-Q contains financial information determined by methods other than Generally Accepted Accounting Principles (GAAP). The table below provides reconciliations between GAAP net earnings and operating net earnings, which exclude gains or losses on items deemed not to reflect core operations. Management uses these non-GAAP financial measures in its analysis of the Company s performance and believes presentations of operating financial measures provide useful supplemental information, a clearer understanding of the Company s performance, and better reflect the Company s core operating activities. Management utilizes non-GAAP measures in the calculation of certain of the Company s ratios, in particular, to analyze on a consistent basis over time the performance of what it considers to be its core operations.

The Company believes the non-GAAP measures enhance investors understanding of the Company s business and performance. These measures are also useful in understanding performance trends and facilitate comparisons with the performance of other financial institutions. The limitations associated with operating measures are the risk that persons might disagree as to the appropriateness of items comprising these measures and that different companies might calculate these measures differently. Management compensates for these limitations by providing detailed reconciliations between GAAP and operating measures. These disclosures should not be considered an alternative to GAAP.

Reconciliation of GAAP to non-GAAP Measures (unaudited):

	2009		2008		
(Dollars in thousands, except per share amounts)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Net earnings, as reported (GAAP)	**$ 932**	**246**	**947**	**1,972**	**1,867**
Non-operating items (net of 37% tax):					
Securities losses (gains), net (a)	724	1,597	796		(33)
Gain on sale of premises and equipment				(675)	
Correction of prior period accounting error				285	
Operating net earnings	**$ 1,656**	**1,843**	**1,743**	**1,582**	**1,834**
Noninterest income (loss), as reported (GAAP)	**$ 1263**	**(89)**	**(224)**	**1,737**	**1,316**
Non-operating items:					
Securities losses (gains), net	758	2,123	1,263		(52)
Gain on sale of premises and equipment				(1,071)	
Correction of prior period accounting error				452	
Operating noninterest income	**$ 2,021**	**2,034**	**1,039**	**1,118**	**1,264**
Total Revenue, as reported (GAAP)	**$ 5,782**	**4,436**	**4,260**	**6,330**	**5,788**
Tax-equivalent adjustment	404	359	353	346	341
Non-operating items:					
Securities losses (gains), net	758	2,123	1,263		(52)
Gain on sale of premises and equipment				(1,071)	
Correction of prior period accounting error				452	
Total Operating Revenue (tax-equivalent)	**$ 6,944**	**6,918**	**5,876**	**6,057**	**6,077**
Net interest income, as reported (GAAP)	**$ 4,519**	**4,525**	**4,484**	**4,593**	**4,472**
Tax-equivalent adjustment	404	359	353	346	341
Net interest income (tax-equivalent)	**$ 4,923**	**4,884**	**4,837**	**4,939**	**4,813**

(a) Any losses for which no tax benefit is recorded are included at the gross amount.

Table of Contents

Reconciliation of GAAP to non-GAAP Measures (unaudited):

(Dollars in thousands, except per share amounts)		Six months ended June 30 2009	2008
Net earnings, as reported (GAAP)	**$**	**1,178**	**3,718**
Non-operating items (net of 37% tax):			
Securities losses (gains), net (a)		2,321	(60)
Gain on sale of premises and equipment			
Correction of prior period accounting error			
Operating net earnings	**$**	**3,499**	**3,658**
Noninterest income (loss), as reported (GAAP)	**$**	**1,174**	**2,689**
Non-operating items:			
Securities losses (gains), net		2,881	(95)
Gain on sale of premises and equipment			
Correction of prior period accounting error			
Operating noninterest income	**$**	**4,055**	**2,594**
Total Revenue, as reported (GAAP)	**$**	**10,218**	**11,482**
Tax-equivalent adjustment		763	662
Non-operating items:			
Securities losses (gains), net		2,881	(95)
Gain on sale of premises and equipment			
Correction of prior period accounting error			
Total Operating Revenue (tax-equivalent)	**$**	**13,862**	**12,049**
Net interest income, as reported (GAAP)	**$**	**9,044**	**8,793**
Tax-equivalent adjustment		763	662
Net interest income (tax-equivalent)	**$**	**9,807**	**9,455**

(a) Any losses for which no tax benefit is recorded are included at the gross amount.

Table of Contents

Table 2 - Selected Quarterly Financial Data

	2009		2008		
(Dollars in thousands, except per share amounts)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Results of Operations					
Net interest income (a)	$ 4,923	4,884	4,837	4,939	4,813
Less: tax-equivalent adjustment	404	359	353	346	341
Net interest income (GAAP)	4,519	4,525	4,484	4,593	4,472
Noninterest income (loss)	1,263	(89)	(224)	1,737	1,316
Total Revenue	5,782	4,436	4,260	6,330	5,788
Provision for loan losses	700	550	250	380	180
Noninterest expense	3,924	3,553	2,992	3,296	3,105
Income tax expense	226	87	71	682	636
Net earnings	$ 932	246	947	1,972	1,867
Per share data:					
Basic and diluted net earnings					
GAAP	$ 0.25	0.07	0.26	0.54	0.51
Operating (b)	0.45	0.51	0.48	0.43	0.50
Cash dividends declared	0.190	0.190	0.185	0.185	0.185
Weighted average shares outstanding:					
Basic and diluted	3,644,491	3,646,827	3,658,193	3,677,509	3,680,144
Shares outstanding, at period end	3,644,097	3,644,957	3,646,947	3,676,836	3,677,823
Book value	$ 14.53	15.14	15.66	14.09	14.51
Common stock price					
High	$ 30.00	26.40	23.97	25.00	23.71
Low	21.75	18.07	19.06	22.10	21.50
Period end:	28.50	21.00	20.10	24.00	22.10
To earnings ratio	25.22x	15.22	11.10	11.82	11.28
To book value	196%	139	128	170	152
Performance ratios:					
Return on average equity					
GAAP	6.63%	1.70	7.25	14.42	13.09
Operating (b)	11.77%	12.70	13.34	11.56	12.86
Return on average assets					
GAAP	0.46%	0.13	0.52	1.09	1.02
Operating (b)	0.82%	0.95	0.96	0.88	1.00
Dividend payout ratio	76.00%	271.43	71.15	34.26	36.27
Asset Quality:					
Allowance for loan losses as a % of:					
Loans	1.24%	1.21	1.19	1.19	1.17
Nonperforming assets	80%	97	92	80	76
Nonperforming assets as a % of:					
Loans and foreclosed properties	1.53%	1.24	1.29	1.50	1.55
Total assets	0.72%	0.58	0.64	0.72	0.73
Nonaccrual loans as a % of total loans	0.17%	1.21	1.20	1.33	1.43
Net charge-offs as a % of average loans	0.63%	0.45	0.09	0.23	0.24
Capital Adequacy:					
Tier 1 risk-based capital ratio	13.81%	13.76	14.23	14.54	14.59

Total risk-based capital ratio	14.82%	14.74	15.22	15.50	15.53
Tier 1 Leverage Ratio	7.89%	8.10	8.75	8.87	8.67
Other financial data:					
Net interest margin (a)	2.64%	2.72	2.84	2.91	2.85
Effective income tax rate	19.52%	26.13	6.97	25.70	25.41
Efficiency ratio					
GAAP	67.87%	80.09	70.23	52.07	53.65
Operating (b)	56.51%	51.36	50.92	54.42	51.09
Selected average balances:					
Securities	$ 353,168	338,435	313,227	322,369	330,020
Loans, net of unearned income	374,465	372,702	360,822	348,093	339,430
Total assets	803,903	779,295	727,417	722,303	732,899
Total deposits	611,224	580,921	525,617	514,840	528,799
Long-term debt	120,997	123,365	126,499	125,906	123,378
Total stockholders equity	56,265	58,051	52,250	54,720	57,062
Selected period end balances:					
Securities	$ 349,472	358,425	302,656	316,148	323,706
Loans, net of unearned income	373,221	374,185	369,162	354,908	345,308
Allowance for loan losses	4,646	4,532	4,398	4,226	4,049
Total assets	800,910	802,450	745,970	734,989	731,306
Total deposits	616,442	609,206	550,843	525,353	540,492
Long-term debt	118,358	123,363	123,368	128,372	123,381
Total stockholders equity	52,948	55,180	57,128	51,810	53,352

*Certain amounts reported in prior periods have been reclassified to conform to the current-period presentation.

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

(b) Operating measures. See Explanation of Non-GAAP Financial Measures.

Table of Contents

Table 3 - Selected Financial Data

(Dollars in thousands, except per share amounts)	**Six months ended June 30 2009**	**2008**
Results of Operations		
Net interest income (a)	$ 9,807	9,455
Less: tax-equivalent adjustment	763	662
Net interest income (GAAP)	9,044	8,793
Noninterest income (loss)	1,174	2,689
Total Revenue	10,218	11,482
Provision for loan losses	1,250	240
Noninterest expense	7,477	6,254
Income tax expense	313	1,270
Net earnings	$ 1,178	3,718
Per share data:		
Basic and diluted net earnings		
GAAP	$ 0.32	1.01
Operating (b)	0.96	0.99
Cash dividends declared	0.380	0.370
Weighted average shares outstanding:		
Basic and diluted	3,645,652	3,680,977
Shares outstanding, at period end	3,644,097	3,677,823
Book value	$ 14.53	14.51
Common stock price		
High	$ 30.00	24.50
Low	18.07	21.50
Period end:	28.50	22.10
To earnings ratio	25.22 x	11.28
To book value	196 %	152
Performance ratios:		
Return on average equity		
GAAP	4.12 %	13.40
Operating (b)	12.24 %	13.19
Return on average assets		
GAAP	0.30 %	1.05
Operating (b)	0.88 %	1.03
Dividend payout ratio	118.75 %	36.63
Asset Quality:		
Allowance for loan losses as a % of:		
Loans	1.24 %	1.17
Nonperforming assets	80 %	76
Nonperforming assets as a % of:		
Loans and foreclosed properties	1.53 %	1.55
Total assets	0.72 %	0.73
Nonaccrual loans as a % of total loans	0.17 %	1.43
Net charge-offs as a % of average loans	0.54 %	0.18
Capital Adequacy:		
Tier 1 risk-based capital ratio	13.81 %	14.59
Total risk-based capital ratio	14.82 %	15.53

Tier 1 Leverage Ratio	7.89 %	8.67
Other financial data:		
Net interest margin (a)	2.68 %	2.86
Effective income tax rate	20.99 %	25.46
Efficiency ratio		
GAAP	73.17 %	54.47
Operating (b)	53.94 %	51.90
Selected average balances:		
Securities	$ 345,843	324,157
Loans, net of unearned income	373,588	334,641
Total assets	791,667	711,220
Total deposits	596,158	520,121
Long-term debt	122,174	119,979
Total stockholders equity	57,150	55,474
Selected period end balances:		
Securities	$ 349,472	323,706
Loans, net of unearned income	373,221	345,308
Allowance for loan losses	4,646	4,049
Total assets	800,910	731,306
Total deposits	616,442	540,492
Long-term debt	118,358	123,381
Total stockholders equity	52,948	53,352

*Certain amounts reported in prior periods have been reclassified to conform to the current-period presentation.

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

(b) Operating measures. See Explanation of Non-GAAP Financial Measures.

Table of Contents

Table 4 - Average Balances and Net Interest Income Analysis

	Quarter ended June 30					
	2009			2008		
(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)	$ 379,162	$ 5,430	5.74%	$ 341,940	$ 5,564	6.54%
Securities - taxable	279,464	3,025	4.34%	266,839	3,321	5.01%
Securities - tax-exempt (2)	73,704	1,188	6.47%	63,181	1,003	6.38%
Total securities	353,168	4,213	4.78%	330,020	4,324	5.27%
Federal funds sold	13,944	8	0.23%	7,137	38	2.14%
Interest bearing bank deposits	1,923	1	0.10%	453	2	1.78%
Total interest-earning assets	748,197	$ 9,652	5.17%	679,550	$ 9,928	5.88%
Cash and due from banks	16,618			12,998		
Other assets	39,088			40,351		
Total assets	$ 803,903			$ 732,899		
Interest-bearing liabilities:						
Deposits:						
NOW	$ 92,131	$ 244	1.06%	$ 86,410	$ 401	1.87%
Savings and money market	95,247	283	1.19%	104,628	409	1.57%
Certificates of deposits less than $100,000	148,043	1,142	3.09%	102,996	1,126	4.40%
Certificates of deposits and other time deposits of $100,000 or more	195,817	1,836	3.76%	162,480	1,868	4.62%
Total interest-bearing deposits	531,238	3,505	2.65%	456,514	3,804	3.35%
Short-term borrowings	11,760	15	0.51%	10,262	43	1.69%
Long-term debt	120,997	1,209	4.01%	123,378	1,268	4.13%
Total interest-bearing liabilities	663,995	$ 4,729	2.86%	590,154	$ 5,115	3.49%
Noninterest-bearing deposits	79,986			72,285		
Other liabilities	3,657			13,398		
Stockholders equity	56,265			57,062		
Total liabilities and stockholders equity	$ 803,903			$ 732,899		
Net interest income and margin		$ 4,923	2.64%		$ 4,813	2.85%

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

Table of Contents

Table 5 - Average Balances and Net Interest Income Analysis

	Six months ended June 30					
	2009			2008		
(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)	$ 378,365	$ 10,776	5.74%	$ 337,340	$ 11,366	6.79%
Securities - taxable	275,937	6,252	4.57%	262,943	6,611	5.07%
Securities - tax-exempt (2)	69,906	2,244	6.47%	61,214	1,947	6.41%
Total securities	345,843	8,496	4.95%	324,157	8,558	5.32%
Federal funds sold	12,607	14	0.22%	4,825	53	2.21%
Interest bearing bank deposits	1,423	1	0.14%	605	11	3.66%
Total interest-earning assets	738,238	$ 19,287	5.27%	666,927	$ 19,988	6.04%
Cash and due from banks	16,756			13,159		
Other assets	36,673			31,134		
Total assets	$ 791,667			$ 711,220		
Interest-bearing liabilities:						
Deposits:						
NOW	$ 89,290	$ 453	1.02%	$ 75,944	$ 802	2.13%
Savings and money market	92,121	555	1.21%	115,918	1,133	1.97%
Certificates of deposits less than $100,000	145,607	2,282	3.16%	96,966	2,334	4.85%
Certificates of deposits and other time deposits of $100,000 or more	191,954	3,739	3.93%	160,108	3,604	4.54%
Total interest-bearing deposits	518,972	7,029	2.73%	448,936	7,873	3.54%
Short-term borrowings	12,277	31	0.51%	11,902	139	2.36%
Long-term debt	122,174	2,420	3.99%	119,979	2,521	4.24%
Total interest-bearing liabilities	653,423	$ 9,480	2.93%	580,817	$ 10,533	3.66%
Noninterest-bearing deposits	77,186			71,185		
Other liabilities	3,908			3,744		
Stockholders equity	57,150			55,474		
Total liabilities and stockholders equity	$ 791,667			$ 711,220		
Net interest income and margin		$ 9,807	2.68%		$ 9,455	2.86%

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

Table of Contents

Table 6 - Loan Portfolio Composition

	2009		2008		
(In thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Commercial, financial and agricultural	$ 52,106	52,147	53,542	50,743	51,380
Leases - commercial	291	316	341	374	431
Construction and land development	53,304	70,828	67,420	67,520	65,792
Real estate - mortgage:					
Commercial	147,843	137,253	132,818	123,367	115,746
Residential	108,576	103,004	102,835	100,540	98,752
Consumer installment	11,330	10,887	12,463	12,663	13,491
Total loans	373,450	374,435	369,419	355,207	345,592
Less: unearned Income	(229)	(250)	(257)	(299)	(284)
	373,221	374,185	369,162	354,908	345,308
Less: Allowance for loan losses	(4,646)	(4,532)	(4,398)	(4,226)	(4,049)
Loans, net	$ 368,575	369,653	364,764	350,682	341,259

Table 7 - Allowance for Loan Losses and Nonperforming Assets

	2009		2008		
(Dollars in thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Allowance for loan losses:					
Balance at beginning of period	$ 4,532	4,398	4,226	4,049	4,074
Charge-offs	(626)	(441)	(88)	(238)	(240)
Recoveries	40	25	10	35	35
Net (charge-offs) recoveries	(586)	(416)	(78)	(203)	(205)
Provision for loan losses	700	550	250	380	180
Ending balance	$ 4,646	4,532	4,398	4,226	4,049
as a % of loans	1.24%	1.21	1.19	1.19	1.17
as a % of nonperforming assets	80%	97	92	80	76
Net charge-offs as a % of average loans	0.63%	0.45	0.09	0.23	0.24
Nonperforming assets:					
Nonaccrual loans	$ 645	4,537	4,431	4,721	4,926
Other nonperforming assets (primarily other real estate owned)	5,149	113	324	594	422
Total nonperforming assets	$ 5,794	4,650	4,755	5,315	5,348
as a % of loans and foreclosed properties	1.53%	1.24	1.29	1.50	1.55
as a % of total assets	0.72%	0.58	0.64	0.72	0.73
Nonaccrual loans as a % of loans	0.17%	1.21	1.20	1.33	1.43
Accruing loans 90 days or more past due	$ 28	56	104		

Table of Contents

Table 8 - Allocation of Allowance for Loan Losses

	2009				2008					
	Second Quarter		First Quarter		Fourth Quarter		Third Quarter		Second Quarter	
(Dollars in thousands)	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial, financial and agricultural	$ 524	14.0	$ 399	13.9	$ 415	14.5	$ 391	14.3	$ 392	14.9
Leases - commercial	2	0.1	2	0.1	2	0.1	3	0.1	3	0.1
Construction and land development	816	14.3	918	18.9	873	18.3	874	19.0	781	19.0
Real estate - mortgage:										
Commercial	1,333	39.6	1,215	36.7	1,175	36.0	1,091	34.7	1,062	33.5
Residential	1,712	29.1	1,452	27.5	1,430	27.8	1,408	28.3	1,368	28.6
Consumer installment	140	3.0	143	2.9	166	3.4	167	3.6	186	3.9
Unallocated	119		403		337		292		257	
Total allowance for loan losses	$ 4,646	100.0	$ 4,532	100.0	$ 4,398	100.0	$ 4,226	100.0	$ 4,049	100.0

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

Table of Contents

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

(Dollars in thousands)		**June 30, 2009**
Maturity of:		
3 months or less	$	58,003
Over 3 months through 6 months		31,921
Over 6 months through 12 months		51,525
Over 12 months		79,034
Total CDs and other time deposits of $100,000 or more	$	220,483

Table of Contents

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 are 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.

Table of Contents

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, 2008.

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, 2008, which could materially affect our business, financial condition or future results. The risks described in our annual report on Form 10-K are not 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 [1]

Period[1]	Total Number of Shares Purchased[2]	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs[3]	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
April 1 April 30	500	$23.00	500	162,513
May 1 May 31				162,513
June 1 June 30	400	$26.95	400	162,113
Total	900	$24.76	900	162,113

[1] Based on trade date, not settlement date.

[2] A total of 900 shares were purchased in privately negotiated transactions.

[3] On April 8, 2008, the Company s Board of Directors authorized a stock repurchase program pursuant to which the Company was authorized to repurchase up to 200 thousand shares of its common stock. As of June 30, 2009, approximately 162 thousand shares are still authorized for purchase under the April 2008 authorization. The April 2008 authorization will expire February 28, 2010.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Shareholders of the Company was held at the AuburnBank Center in Auburn, Alabama, on Tuesday, May 12, 2009, at 3:00 p.m. This meeting was held for the purpose of considering the election of 11 directors to the Board of Directors to serve one-year terms expiring at the Company s 2010 Annual Meeting of Shareholders and until their successors have been elected and qualified.

Table of Contents

As to the election of 11 directors, E.L. Spencer, Jr., Emil F. Wright, Jr., C. Wayne Alderman, Terry Andrus, J. Tutt Barrett, Robert W. Dumas, J.E. Evans, William F. Ham, Jr., David E. Housel, Anne M. May, and Edward Lee Spencer III were all elected to the Board of Directors. The numbers of votes cast were as follows:

	Votes cast for Election	Votes cast to Withhold Authority
E.L. Spencer, Jr.	3,135,191	7,407
Emil F. Wright, Jr.	3,135,191	7,407
C. Wayne Alderman	3,106,140	36,458
Terry Andrus	3,106,140	36,458
J. Tutt Barrett	3,134,014	8,584
Robert W. Dumas	3,135,191	7,407
J.E. Evans	3,104,888	37,710
William F. Ham, Jr.	3,135,191	7,407
David E. Housel	3,134,014	8,584
Anne M. May	3,135,191	7,407
Edward Lee Spencer III	3,135,191	7,407

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 E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.***
32.2	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Vice President, Controller and Chief Financial Officer (Principal Financial and Accounting Officer).***

* 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 accompany this Quarterly Report on Form 10-Q and 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.

SIGNATURES

In accordance with 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: August 13, 2009	By: /s/ E. L. Spencer, Jr. E. L. Spencer, Jr. President, Chief Executive Officer and Chairman of the Board
Date: August 13, 2009	By: /s/ David A. Hedges David A. Hedges VP, Controller and Chief Financial officer (Principal Financial and Accounting Officer)