

AUBURN NATIONAL BANCORPORATION, INC
Form 10-Q
October 30, 2015
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

- Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended September 30, 2015
- Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period _____ to _____
Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

100 N. Gay Street

63-0885779
(I.R.S. Employer
Identification No.)

Auburn, Alabama 36830

(334) 821-9200

(Address and telephone number of principal executive offices)

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

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

Yes

No

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

Yes

No

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

Large Accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting
company

(Do not check if a smaller reporting company)

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

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

Class	Outstanding at October 30, 2015
Common Stock, \$0.01 par value per share	3,643,478 shares

Table of Contents**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****INDEX**

<u>PART I. FINANCIAL INFORMATION</u>	PAGE
Item 1 <u>Financial Statements</u>	
<u>Consolidated Balance Sheets (Unaudited)</u> <u>as of September 30, 2015 and December 31, 2014</u>	3
<u>Consolidated Statements of Earnings (Unaudited)</u> <u>for the quarter and nine months ended September 30, 2015 and 2014</u>	4
<u>Consolidated Statements of Comprehensive Income (Unaudited)</u> <u>for the quarter and nine months ended September 30, 2015 and 2014</u>	5
<u>Consolidated Statements of Stockholders' Equity (Unaudited)</u> <u>for the nine months ended September 30, 2015 and 2014</u>	6
<u>Consolidated Statements of Cash Flows (Unaudited)</u> <u>for the nine months ended September 30, 2015 and 2014</u>	7
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	8
Item 2 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	31
Table 1 <u>Explanation of Non-GAAP Financial Measures</u>	49
Table 2 <u>Selected Quarterly Financial Data</u>	50
Table 3 <u>Selected Financial Data</u>	51
Table 4 <u>Average Balances and Net Interest Income Analysis for the quarter ended</u> <u>September 30, 2015 and 2014</u>	52
Table 5 <u>Average Balances and Net Interest Income Analysis for the nine months</u> <u>ended September 30, 2015 and 2014</u>	53
Table 6 <u>Loan Portfolio Composition</u>	54
Table 7 <u>Allowance for Loan Losses and Nonperforming Assets</u>	55
Table 8 <u>Allocation of Allowance for Loan Losses</u>	56
Table 9 <u>CDs and Other Time Deposits of \$100,000 or more</u>	57
Item 3 <u>Quantitative and Qualitative Disclosures About Market Risk</u>	58
Item 4 <u>Controls and Procedures</u>	58
<u>PART II. OTHER INFORMATION</u>	
Item 1 <u>Legal Proceedings</u>	58

Item 1A	<u>Risk Factors</u>	58
Item 2	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	58
Item 3	<u>Defaults Upon Senior Securities</u>	58
Item 4	<u>Mine Safety Disclosures</u>	58
Item 5	<u>Other Information</u>	58
Item 6	<u>Exhibits</u>	59

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

	September 30,	December 31,
<i>(Dollars in thousands, except share data)</i>	2015	2014
Assets:		
Cash and due from banks	\$ 15,552	\$ 12,856
Federal funds sold	56,915	68,507
Interest bearing bank deposits	37,133	2,140
Cash and cash equivalents	109,600	83,503
Securities available-for-sale	250,142	267,603
Loans held for sale	3,551	1,974
Loans, net of unearned income	422,572	402,954
Allowance for loan losses	(5,127)	(4,836)
Loans, net	417,445	398,118
Premises and equipment, net	11,666	10,807
Bank-owned life insurance	17,314	18,004
Other real estate owned	278	534
Other assets	7,998	8,688
Total assets	\$ 817,994	\$ 789,231
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 155,614	\$ 130,160
Interest-bearing	568,697	563,230
Total deposits	724,311	693,390
Federal funds purchased and securities sold under agreements to repurchase	3,447	4,681
Long-term debt	7,217	12,217

Accrued expenses and other liabilities	3,420	3,144
Total liabilities	738,395	713,432
Stockholders equity:		
Preferred stock of \$.01 par value; authorized 200,000 shares; no issued shares		
Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,766	3,763
Retained earnings	79,710	76,193
Accumulated other comprehensive income, net	2,722	2,443
Less treasury stock, at cost - 313,657 shares and 313,807 shares at September 30, 2015 and December 31, 2014, respectively	(6,638)	(6,639)
Total stockholders equity	79,599	75,799
Total liabilities and stockholders equity	\$ 817,994	\$ 789,231

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Unaudited)

Quarter ended September 30, Nine Months Ended September 30,

(In thousands, except share and per share data)

	2015	2014	2015	2014
Interest income:				
Loans, including fees	\$ 5,090	\$ 4,953	\$ 15,313	\$ 14,509
Securities:				
Taxable	939	1,171	2,928	3,561
Tax-exempt	664	622	1,969	1,856
Federal funds sold and interest bearing bank deposits	57	33	147	105
Total interest income	6,750	6,779	20,357	20,031
Interest expense:				
Deposits	1,017	1,221	3,139	3,733
Short-term borrowings	4	5	14	14
Long-term debt	59	105	223	313
Total interest expense	1,080	1,331	3,376	4,060
Net interest income	5,670	5,448	16,981	15,971
Provision for loan losses	200	300	200	(100)
Net interest income after provision for loan losses	5,470	5,148	16,781	16,071
Noninterest income:				
Service charges on deposit accounts	209	228	624	660
Mortgage lending	362	534	1,153	1,268
Bank-owned life insurance	116	124	629	375
Other	358	366	1,124	1,081
Securities gains (losses), net:				
Realized gains (losses), net	11	(235)	14	(197)
Total other-than-temporary impairments				(333)
Total securities gains (losses), net	11	(235)	14	(530)

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Total noninterest income	1,056	1,017	3,544	2,854
Noninterest expense:				
Salaries and benefits	2,255	2,199	6,814	6,701
Net occupancy and equipment	405	346	1,125	1,039
Professional fees	191	204	610	635
FDIC and other regulatory assessments	120	125	363	399
Other real estate owned, net	1	(237)	19	(181)
Prepayment penalties on long-term debt			362	
Other	920	947	2,942	2,731
Total noninterest expense	3,892	3,584	12,235	11,324
Earnings before income taxes	2,634	2,581	8,090	7,601
Income tax expense	724	709	2,168	2,049
Net earnings	\$ 1,910	\$ 1,872	\$ 5,922	\$ 5,552
Net earnings per share:				
Basic and diluted	\$ 0.52	\$ 0.51	\$ 1.63	\$ 1.52
Weighted average shares outstanding:				
Basic and diluted	3,643,455	3,643,328	3,643,411	3,643,262

See accompanying notes to consolidated financial statements

Table of Contents**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income****(Unaudited)****Quarter ended September 30, Nine Months Ended September 30,**

<i>(Dollars in thousands)</i>	2015	2014	2015	2014
Net earnings	\$ 1,910	\$ 1,872	\$ 5,922	\$ 5,552
Other comprehensive income (loss), net of tax:				
Unrealized net holding gain (loss) on securities	1,444	(335)	288	5,167
Reclassification adjustment for net (gain) loss on securities recognized in net earnings	(7)	149	(9)	335
Other comprehensive income (loss)	1,437	(186)	279	5,502
Comprehensive income	\$ 3,347	\$ 1,686	\$ 6,201	\$ 11,054

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity

(Unaudited)

	Accumulated								
	Common Stock		Additional paid-in		Retained earnings		comprehensive income	Treasury stock	Total
	Shares	Amount	capital	earnings	income	stock	Total		
<i>(Dollars in thousands, except share data)</i>									
Balance, December 31, 2013	3,957,135	\$ 39	\$ 3,759	\$ 71,879	\$ (4,552)	\$ (6,640)	\$ 64,485		
Net earnings				5,552			5,552		
Other comprehensive income					5,502		5,502		
Cash dividends paid (\$0.645 per share)				(2,351)			(2,351)		
Sale of treasury stock (210 shares)			4			1	5		
Balance, September 30, 2014	3,957,135	\$ 39	\$ 3,763	\$ 75,080	\$ 950	\$ (6,639)	\$ 73,193		
Balance, December 31, 2014	3,957,135	\$ 39	\$ 3,763	\$ 76,193	\$ 2,443	\$ (6,639)	\$ 75,799		
Net earnings				5,922			5,922		
Other comprehensive income					279		279		
Cash dividends paid (\$0.66 per share)				(2,405)			(2,405)		
Sale of treasury stock (150 shares)			3			1	4		
Balance, September 30, 2015	3,957,135	\$ 39	\$ 3,766	\$ 79,710	\$ 2,722	\$ (6,638)	\$ 79,599		

See accompanying notes to consolidated financial statements

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

<i>(In thousands)</i>	Nine Months Ended September 30,	
	2015	2014
Cash flows from operating activities:		
Net earnings	\$ 5,922	\$ 5,552
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	200	(100)
Depreciation and amortization	863	557
Premium amortization and discount accretion, net	1,186	1,150
Net (gain) loss on securities available-for-sale	(14)	530
Net gain on sale of loans held for sale	(942)	(880)
(Decrease) increase in MSR valuation allowance	(52)	31
Net loss (gain) on other real estate owned	6	(204)
Loss on prepayment of long-term debt	362	
Loans originated for sale	(55,956)	(44,185)
Proceeds from sale of loans	54,882	43,469
Increase in cash surrender value of bank-owned life insurance	(353)	(375)
Income recognized from death benefit on bank-owned life insurance	(276)	
Net decrease (increase) in other assets	293	(82)
Net increase in accrued expenses and other liabilities	280	8,200
Net cash provided by operating activities	6,401	13,663
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale		37,132
Proceeds from maturities of securities available-for-sale	23,981	47,241
Purchase of securities available-for-sale	(7,249)	(70,943)
Increase in loans, net	(19,527)	(12,126)
Net purchases of premises and equipment	(1,189)	(19)
Proceeds from bank-owned life insurance death benefit	1,319	
Decrease in FHLB stock	191	235
Proceeds from sale of other real estate owned	250	3,322
Net cash (used in) provided by investing activities	(2,224)	4,842
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	25,454	1,732

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Net increase in interest-bearing deposits	5,467	10,187
Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase	(1,234)	971
Repayments or retirement of long-term debt	(5,362)	
Dividends paid	(2,405)	(2,351)
Net cash provided by financing activities	21,920	10,539
Net change in cash and cash equivalents	26,097	29,044
Cash and cash equivalents at beginning of period	83,503	54,222
Cash and cash equivalents at end of period	\$ 109,600	\$ 83,266

Supplemental disclosures of cash flow information:

Cash paid during the period for:		
Interest	\$ 3,503	\$ 4,125
Income taxes	1,803	963

Supplemental disclosure of non-cash transactions:

Real estate acquired through foreclosure		449
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See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

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

Basis of Presentation and Use of Estimates

The unaudited consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The unaudited consolidated financial statements include, in the opinion of management, all adjustments necessary to present a fair statement of the financial position and the results of operations for all periods presented. All such adjustments are of a normal recurring nature. The results of operations in the interim statements are not necessarily indicative of the results of operations that the Company and its subsidiaries may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

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

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include other-than-temporary impairment on investment securities, the determination of the allowance for loan losses, fair value of financial instruments, and the valuation of deferred tax assets and other real estate owned.

Subsequent Events

The Company has evaluated the effects of events and transactions through the date of this filing that have occurred subsequent to September 30, 2015. The Company does not believe there were any material subsequent events during this period that would have required further recognition or disclosure in the unaudited consolidated financial statements included in this report.

Accounting Developments

In the first quarter of 2015, the Company adopted new guidance related to the following Accounting Standards Updates (Updates or ASUs):

ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*;

ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*;

ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*;

ASU 2014-11, *Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*; and

ASU 2014-14, *Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*.

Table of Contents

Information about these pronouncements is described in more detail below.

ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*, amends the criteria a company must meet to elect to account for investments in qualified affordable housing projects using a method other than the cost or equity methods. If the criteria are met, a company is permitted to amortize the initial investment cost in proportion to and over the same period as the total tax benefits the company expects to receive. The amortization of the initial investment cost and tax benefits are to be recorded in the income tax expense line. The Update also requires new disclosures about all investments in qualified affordable housing projects regardless of the accounting method used. These changes were effective for the Company in the first quarter of 2015. Adoption of this ASU did not have a material impact on the consolidated financial statements of the Company.

ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*, clarifies the timing of when a creditor is considered to have taken physical possession of residential real estate collateral for a consumer mortgage loan, resulting in the reclassification of the loan receivable to real estate owned. A creditor has taken physical possession of the property when either (1) the creditor obtains legal title through foreclosure, or (2) the borrower transfers all interests in the property to the creditor via a deed in lieu of foreclosure or a similar legal agreement. The Update also requires disclosure of the amount of foreclosed residential real estate property held by the creditor and the recorded investment in residential real estate mortgage loans that are in the process of foreclosure. These changes were effective for the Company in the first quarter of 2015. Adoption of this ASU did not have a material impact on the consolidated financial statements of the Company.

ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*, changes the definition and reporting requirements for discontinued operations. Under the new guidance, an entity's disposal of a component or group of components must be reported in discontinued operations if the disposal is a strategic shift that has or will have a significant effect on the entity's operations and financial results. Major strategic shifts include disposals of a major geographic area or line of business. This guidance also requires new disclosures on discontinued operations. These changes were effective for the Company in the first quarter 2015. Adoption of this ASU did not have a material impact on the consolidated financial statements of the Company.

ASU 2014-11, *Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*, changes current accounting and expands secured borrowing accounting for repurchase-to-maturity transactions and repurchase financings. This guidance requires new disclosures for certain repurchase agreements and similar transactions that identify which items are accounted for as secured borrowings and which items are accounted for as sales. These changes were effective for the Company in the first quarter 2015. Adoption of this ASU did not have a material impact on the consolidated financial statements of the Company.

ASU No. 2014-14, *Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*, clarifies how creditors classify government-guaranteed mortgage loans, including FHA or VA guaranteed loans, upon foreclosure. Some creditors reclassify those loans to real estate consistent with other foreclosed loans that do not have guarantees; others reclassify the loans to other receivables. The amendments in this guidance require that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) The loan has a government guarantee that is not separable from the loan before foreclosure; (2) At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. These changes were effective for the Company in the first quarter of 2015. Adoption of this ASU did not have a material 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 respective period. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company's common stock. At September 30, 2015 and 2014, respectively, the Company had no such securities or rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted earnings per share calculation.

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

Quarter ended September 30, Nine Months Ended September 30,

(In thousands, except share and per share data)

	2015		2014	
Basic and diluted:				
Net earnings	\$ 1,910	\$ 1,872	\$ 5,922	\$ 5,552
Weighted average common shares outstanding	3,643,455	3,643,328	3,643,411	3,643,262
Earnings per share	\$ 0.52	\$ 0.51	\$ 1.63	\$ 1.52

NOTE 3: VARIABLE INTEREST ENTITIES

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

At September 30, 2015, the Company did not have any consolidated VIEs to disclose but did have one nonconsolidated VIE, discussed below.

Trust Preferred Securities

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

The following table summarizes VIEs that are not consolidated by the Company as of September 30, 2015.

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

Table of Contents**NOTE 4: SECURITIES**

At September 30, 2015 and December 31, 2014, respectively, all securities within the scope of Accounting Standards Codification (ASC) 320, *Investments – Debt and Equity Securities*, were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at September 30, 2015 and December 31, 2014, respectively, are presented below.

	1 year	1 to 5	5 to 10	After 10	Fair	Gross Unrealized		Amortized
<i>(Dollars in thousands)</i>	or less	years	years	years	Value	Gains	Losses	Cost
September 30, 2015								
Agency obligations (a)	\$ 5,007	26,185	19,546	9,817	60,555	720	408	\$ 60,243
Agency RMBS (a)		1,767	14,470	101,066	117,303	1,539	301	116,065
State and political subdivisions		1,059	13,232	57,993	72,284	2,861	96	69,519
Total available-for-sale	\$ 5,007	29,011	47,248	168,876	250,142	5,120	805	\$ 245,827
December 31, 2014								
Agency obligations (a)	\$	30,947	14,869	14,433	60,249	375	830	\$ 60,704
Agency RMBS (a)			14,523	120,520	135,043	1,597	616	134,062
State and political subdivisions		502	15,520	56,289	72,311	3,379	34	68,966
Total available-for-sale	\$	31,449	44,912	191,242	267,603	5,351	1,480	\$ 263,732

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

Securities with aggregate fair values of \$136.1 million and \$132.2 million at September 30, 2015 and December 31, 2014, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

Included in other assets are cost-method investments. The carrying amounts of cost-method investments were \$1.4 million and \$1.6 million at September 30, 2015 and December 31, 2014, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (FRB) stock.

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at September 30, 2015 and December 31, 2014, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer, are presented below.

	Less than 12 Months		12 Months or Longer		Total			
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized		
<i>(Dollars in thousands)</i>	Value	Losses	Value	Losses	Value	Losses		
September 30, 2015:								
Agency obligations	\$		24,550	408	\$	24,550	408	
Agency RMBS	18,567	94	19,031	207	37,598	301		
State and political subdivisions	7,705	96			7,705	96		
Total	\$	26,272	190	43,581	615	\$	69,853	805
December 31, 2014:								
Agency obligations	\$		24,126	830	\$	24,126	830	
Agency RMBS	9,078	22	42,744	594	51,822	616		
State and political subdivisions	4,257	34			4,257	34		
Total	\$	13,335	56	66,870	1,424	\$	80,205	1,480

Table of Contents

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

Agency obligations

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

Agency RMBS

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

Securities of U.S. states and political subdivisions

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

Cost-method investments

At September 30, 2015, cost-method investments with an aggregate cost of \$1.4 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

The carrying values of the Company's investment securities could decline in the future if the financial condition of an issuer deteriorates and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that other-than-temporary impairment charges may occur in the future.

Other-Than-Temporarily Impaired Securities

Credit-impaired debt securities are debt securities where the Company has written down the amortized cost basis of a security for other-than-temporary impairment and the credit component of the loss is recognized in earnings. At September 30, 2015 and December 31, 2014, the Company had no credit-impaired debt securities and there were no additions or reductions in the credit loss component of credit-impaired debt securities during the nine months ended September 30, 2015 and 2014, respectively.

Table of Contents**Other-Than-Temporary Impairment**

The following table presents details of the other-than-temporary impairment related to securities.

Quarter ended September 30, 2015 **Nine Months Ended September 30,**

(Dollars in thousands)

	2015	2014	2015	2014
Other-than-temporary impairment charges (included in earnings):				
Debt securities:				
Agency RMBS	\$	\$	\$	\$ 333
Total debt securities				333
Total other-than-temporary impairment charges (included in earnings):	\$	\$	\$	\$ 333
Other-than-temporary impairment on debt securities:				
Recorded as part of gross realized losses:				
Securities with intent to sell				333
Total other-than-temporary impairment on debt securities	\$	\$	\$	\$ 333

Realized Gains and Losses

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

Quarter ended September 30, 2015 **Nine Months Ended September 30,**

(Dollars in thousands)

	2015	2014	2015	2014
Gross realized gains	\$ 11	\$ 429	\$ 14	\$ 467
Gross realized losses		(664)		(664)
Realized gains (losses), net	\$ 11	\$ (235)	\$ 14	\$ (197)

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

	September 30,	December 31,
<i>(In thousands)</i>	2015	2014
Commercial and industrial	\$ 47,925	\$ 54,329
Construction and land development	41,592	37,298
Commercial real estate:		
Owner occupied	48,445	52,296
Other	153,004	139,710
Total commercial real estate	201,449	192,006
Residential real estate:		
Consumer mortgage	71,415	66,489
Investment property	46,448	41,152
Total residential real estate	117,863	107,641
Consumer installment	14,362	12,335
Total loans	423,191	403,609
Less: unearned income	(619)	(655)
Loans, net of unearned income	\$ 422,572	\$ 402,954

Loans secured by real estate were approximately 85.3% of the Company's total loan portfolio at September 30, 2015. At September 30, 2015, the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama, and surrounding areas.

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

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

Commercial and industrial (C&I) includes loans to finance business operations, equipment purchases, or other needs for small and medium-sized commercial customers. Also included in this category are loans to finance agricultural production. Generally, the primary source of repayment is the cash flow from business operations and activities of the borrower.

Construction and land development (C&D) includes both loans and credit lines for the purpose of purchasing, carrying, and developing land into commercial developments or residential subdivisions. Also included are loans and credit lines for construction of residential, multi-family, and commercial buildings. Generally, the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

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

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

Other primarily includes loans to finance income-producing commercial and multi-family properties that are not owner occupied. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, warehouses, and apartments leased to local businesses and residents. Generally, the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates, as well as the financial health of the borrower.

Table of Contents

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

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

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

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

The following is a summary of current, accruing past due, and nonaccrual loans by portfolio segment and class as of September 30, 2015 and December 31, 2014.

	Accruing		Accruing	Total		
	30-89 Days		Greater than	Accruing	Non-	Total
(In thousands)	Current	Past Due	90 days	Loans	Accrual	Loans
September 30, 2015:						
Commercial and industrial	\$ 47,807	37		47,844	81	\$ 47,925
Construction and land development	40,886		112	40,998	594	41,592
Commercial real estate:						
Owner occupied	47,586	182		47,768	677	48,445
Other	150,891			150,891	2,113	153,004
Total commercial real estate	198,477	182		198,659	2,790	201,449
Residential real estate:						
Consumer mortgage	70,929	301		71,230	185	71,415
Investment property	46,414	34		46,448		46,448
Total residential real estate	117,343	335		117,678	185	117,863
Consumer installment	14,342	20		14,362		14,362

Total	\$	418,855	574	112	419,541	3,650	\$	423,191
December 31, 2014:								
Commercial and industrial	\$	54,106	168		54,274	55	\$	54,329
Construction and land development		36,483	210		36,693	605		37,298
Commercial real estate:								
Owner occupied		51,832	201		52,033	263		52,296
Other		139,710			139,710			139,710
Total commercial real estate		191,542	201		191,743	263		192,006
Residential real estate:								
Consumer mortgage		64,713	1,736		66,449	40		66,489
Investment property		40,503	495		40,998	154		41,152
Total residential real estate		105,216	2,231		107,447	194		107,641
Consumer installment		12,290	45		12,335			12,335
Total	\$	399,637	2,855		402,492	1,117	\$	403,609

Table of Contents

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates, and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred, which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

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

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

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

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

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

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for each loan segment. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At September 30, 2015 and December 31, 2014, and for the periods then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

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

The Company regularly re-evaluates its practices in determining the allowance for loan losses. During 2014, the Company implemented certain refinements to its allowance for loan losses methodology in order to better capture the effects of the most recent economic cycle on the Company's loan loss experience. Beginning with the quarter ended June 30, 2014, the Company calculated average losses for all loan segments using a rolling 20 quarter historical period and continues to use this methodology.

Table of Contents

Prior to June 30, 2014, the Company calculated average losses for all loan segments using a rolling 8 quarter historical period (except for the commercial real estate loan segment, which used a 6 quarter historical period). If the Company continued to calculate average losses for all loan segments other than commercial real estate using a rolling 8 quarter historical period and for the commercial real estate segment using a rolling 6 quarter historical period, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$1.0 million at June 30, 2014. Other than the changes discussed above, the Company has not made any material changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

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

	September 30, 2015					
	Commercial and industrial	Construction and land development	Commercial real estate	Residential real estate	Consumer installment	Total
<i>(In thousands)</i>						
Quarter ended:						
Beginning balance	\$ 681	640	2,146	1,180	239	\$ 4,886
Charge-offs				(26)	(23)	(49)
Recoveries	13	4		71	2	90
Net recoveries (charge-offs)	13	4		45	(21)	41
Provision for loan losses	(190)	(17)	533	(122)	(4)	200
Ending balance	\$ 504	627	2,679	1,103	214	\$ 5,127
Nine months ended:						
Beginning balance	\$ 639	974	1,928	1,119	176	\$ 4,836
Charge-offs	(58)			(86)	(45)	(189)
Recoveries	17	13		236	14	280
Net (charge-offs) recoveries	(41)	13		150	(31)	91
Provision for loan losses	(94)	(360)	751	(166)	69	200
Ending balance	\$ 504	627	2,679	1,103	214	\$ 5,127
						September 30, 2014
	Commercial and industrial	Construction and land development	Commercial real estate	Residential real estate	Consumer installment	Total
<i>(In thousands)</i>						

Quarter ended:							
Beginning balance	\$	639	907	1,913	1,095	174	\$ 4,728
Charge-offs					(287)	(39)	(326)
Recoveries		35	1		13	3	52
Net recoveries (charge-offs)		35	1		(274)	(36)	(274)
Provision for loan losses		(5)	(13)	22	262	34	300
Ending balance	\$	669	895	1,935	1,083	172	\$ 4,754
Nine months ended:							
Beginning balance	\$	386	366	3,186	1,114	216	\$ 5,268
Charge-offs		(46)	(236)		(358)	(83)	(723)
Recoveries		71	4	118	103	13	309
Net recoveries (charge-offs)		25	(232)	118	(255)	(70)	(414)
Provision for loan losses		258	761	(1,369)	224	26	(100)
Ending balance	\$	669	895	1,935	1,083	172	\$ 4,754

Table of Contents

The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of September 30, 2015 and 2014.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
	Allowance	Recorded	Allowance	Recorded	Allowance	Recorded
	for	investment	for	investment	for	investment
	loan	in loans	loan	in loans	loan	in loans
<i>(In thousands)</i>						
September 30, 2015:						
Commercial and industrial	\$ 504	47,869	56	504	47,925	
Construction and land development	627	40,999	593	627	41,592	
Commercial real estate	1,719	197,693	960	3,756	2,679	201,449
Residential real estate	1,103	117,863		1,103	117,863	
Consumer installment	214	14,362		214	14,362	
Total	\$ 4,167	418,786	960	4,405	5,127	423,191
September 30, 2014:						
Commercial and industrial	\$ 669	52,785	83	669	52,868	
Construction and land development	895	33,574	615	895	34,189	
Commercial real estate	1,733	188,150	202	1,927	1,935	190,077
Residential real estate	1,083	105,672	883	1,083	106,555	
Consumer installment	172	11,535		172	11,535	
Total	\$ 4,552	391,716	202	3,508	4,754	395,224

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

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

Table of Contents**Credit Quality Indicators**

The credit quality of the loan portfolio is summarized no less frequently than quarterly using categories similar to the standard asset classification system used by the federal banking agencies. The following table presents credit quality indicators for the loan portfolio segments and classes. These categories are utilized to develop the associated allowance for loan losses using historical losses adjusted for qualitative and environmental factors and are defined as follows:

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

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

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

Nonaccrual includes loans where management has determined that full payment of principal and interest is not expected.

<i>(In thousands)</i>	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
September 30, 2015:					
Commercial and industrial	\$ 43,379	4,136	329	81	\$ 47,925
Construction and land development	40,360	60	578	594	41,592
Commercial real estate:					
Owner occupied	47,260	284	224	677	48,445
Other	150,577	37	277	2,113	153,004
Total commercial real estate	197,837	321	501	2,790	201,449
Residential real estate:					
Consumer mortgage	65,983	1,407	3,840	185	71,415
Investment property	44,839	485	1,124		46,448
Total residential real estate	110,822	1,892	4,964	185	117,863
Consumer installment	14,137	97	128		14,362
Total	\$ 406,535	6,506	6,500	3,650	\$ 423,191
December 31, 2014:					
Commercial and industrial	\$ 49,550	4,348	376	55	\$ 54,329
Construction and land development	35,911	226	556	605	37,298
Commercial real estate:					

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Owner occupied	49,900	1,905	228	263	52,296
Other	136,801	2,253	656		139,710
Total commercial real estate	186,701	4,158	884	263	192,006
Residential real estate:					
Consumer mortgage	59,646	1,912	4,891	40	66,489
Investment property	39,348	624	1,026	154	41,152
Total residential real estate	98,994	2,536	5,917	194	107,641
Consumer installment	12,200	21	114		12,335
Total	\$ 383,356	11,289	7,847	1,117	\$ 403,609

Table of Contents**Impaired loans**

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

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

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

The following tables set forth certain information regarding the Company's impaired loans that were individually evaluated for impairment at September 30, 2015 and December 31, 2014.

September 30, 2015

<i>(In thousands)</i>	Unpaid principal charge-offs and balance payments applied Recorded			Related allowance
	(1)	(2)	investment (3)	
With no allowance recorded:				
Commercial and industrial	\$ 56		56	
Construction and land development	2,590	(1,997)	593	
Commercial real estate:				
Owner occupied	312	(75)	237	
Total commercial real estate	312	(75)	237	
Total	\$ 2,958	(2,072)	886	
With allowance recorded:				
Commercial real estate:				
Owner occupied	1,476	(70)	1,406	427
Other	2,130	(17)	2,113	533
Total commercial real estate	3,606	(87)	3,519	960
Total	\$ 3,606	(87)	3,519	\$ 960
Total impaired loans	\$ 6,564	(2,159)	4,405	\$ 960

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

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

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

Table of Contents

December 31, 2014

<i>(In thousands)</i>	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
With no allowance recorded:				
Commercial and industrial	\$ 70		70	
Construction and land development	2,822	(2,217)	605	
Commercial real estate:				
Owner occupied	331	(68)	263	
Total commercial real estate	331	(68)	263	
Residential real estate:				
Consumer mortgages	934	(192)	742	
Investment property	180	(26)	154	
Total residential real estate	1,114	(218)	896	
Total	\$ 4,337	(2,503)	1,834	
With allowance recorded:				
Commercial real estate:				
Owner occupied	846		846	102
Other	591		591	92
Total commercial real estate	1,437		1,437	194
Total	\$ 1,437		1,437	\$ 194
Total impaired loans	\$ 5,774	(2,503)	3,271	\$ 194

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

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

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

The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class during the respective periods.

Quarter ended September 30, 2015 months ended September 30, 2015

	Average	Total interest	Average	Total
	recorded	income	recorded	interest
<i>(In thousands)</i>	investment	recognized	investment	recognized
Impaired loans:				
Commercial and industrial	\$ 58	1	63	3
Construction and land development	596		608	
Commercial real estate:				
Owner occupied	1,433	11	1,273	32
Other	921		610	18
Total commercial real estate	2,354	11	1,883	50
Residential real estate:				
Consumer mortgages			454	173
Investment property			91	76
Total residential real estate			545	249
Total	\$ 3,008	12	3,099	302

Table of Contents

	Quarter ended September 30, 2015		Nine months ended September 30, 2014	
	Average	Total interest	Average	Total interest
	recorded	income	recorded	income
(In thousands)	investment	recognized	investment	recognized
Impaired loans:				
Commercial and industrial	\$ 88	2	105	6
Construction and land development	730		1,159	
Commercial real estate:				
Owner occupied	1,129	9	1,367	31
Other	801	4	935	20
Total commercial real estate	1,930	13	2,302	51
Residential real estate:				
Consumer mortgages	716	5	752	5
Investment property	162		166	
Total residential real estate	878	5	918	5
Total	\$ 3,626	20	4,484	62

Interest income recognized for the nine months ended September 30, 2015 included interest recoveries of \$225 thousand related to two impaired residential real estate loans that paid off in June 2015. Excluding the interest recoveries on these two loans, interest income recognized on impaired loans for the nine months ended September 30, 2015 would have been \$77 thousand.

Troubled Debt Restructurings

Impaired loans also include troubled debt restructurings (TDRs). In the normal course of business, management may grant concessions to borrowers that are experiencing financial difficulty. A concession may include, but is not limited to, delays in required payments of principal and interest for a specified period, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date, or reduction of the face amount or maturity amount of the debt. A concession has been granted when, as a result of the restructuring, the Bank does not expect to collect all amounts due, including interest at the original stated rate. A concession may have also been granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. In making the determination of whether a loan modification is a TDR, the Company considers the individual facts and circumstances surrounding each modification. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructure.

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

Table of Contents

The following is a summary of accruing and nonaccrual TDRs, which are included in the impaired loan totals, and the related allowance for loan losses, by portfolio segment and class as of September 30, 2015 and December 31, 2014.

<i>(In thousands)</i>	TDRs			Related Allowance
	Accruing	Nonaccrual	Total	
September 30, 2015				
Commercial and industrial	\$ 56		56	\$
Construction and land development		593	593	
Commercial real estate:				
Owner occupied	1,036	237	1,273	130
Total commercial real estate	1,036	237	1,273	130
Total	\$ 1,092	830	1,922	\$ 130
December 31, 2014				
Commercial and industrial	\$ 70		70	\$
Construction and land development		605	605	
Commercial real estate:				
Owner occupied	846	263	1,109	102
Other	591		591	92
Total commercial real estate	1,437	263	1,700	194
Residential real estate:				
Consumer mortgages	742		742	
Investment property		154	154	
Total residential real estate	742	154	896	
Total	\$ 2,249	1,022	3,271	\$ 194

At September 30, 2015, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

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

Quarter ended September 30,	Nine months ended September 30,
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	Pre-		Post -		Pre-		Post -	
	modification		modification		modification		modification	
	Number outstanding		outstanding		Number outstanding		outstanding	
	of recorded		recorded		of recorded		recorded	
<i>(Dollars in thousands)</i>	contracts investment		investment		contracts investment		investment	
2015:								
Commercial and industrial		\$			1	\$	61	66
Construction and land development					1		116	113
Commercial real estate:								
Owner occupied	1	216		218	1	216		218
Other					1	592		592
Total commercial real estate	1	216		218	2	808		810
Total	1	\$ 216		218	4	\$ 985		989
2014:								
Commercial real estate:								
Other	1	\$ 590		592	1	\$ 590		592
Total commercial real estate	1	590		592	1	590		592
Residential real estate:								
Consumer mortgages	1	712		712	1	712		712
Total residential real estate	1	712		712	1	712		712
Total	2	\$ 1,302		1,304	2	\$ 1,302		1,304

Table of Contents

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

The following table summarizes the recorded investment in loans modified in a TDR within the previous 12 months for which there was a payment default (defined as 90 days or more past due) during the respective periods.

	Quarter ended September 30,		Nine months Ended September 30,	
	Number of	Recorded	Number of	Recorded
	Contracts	investment ⁽¹⁾	Contracts	investment ⁽¹⁾
<i>(Dollars in thousands)</i>				
2015:				
Commercial real estate:				
Owner occupied		\$	1	\$ 261
Total commercial real estate			1	261
Residential real estate:				
Investment property			1	150
Total residential real estate			1	150
Total		\$	2	\$ 411
2014:				
Commercial real estate:				
Owner occupied	1	\$ 272	1	\$ 272
Total commercial real estate	1	272	1	272
Total	1	\$ 272	1	\$ 272

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

NOTE 6: MORTGAGE SERVICING RIGHTS, NET

Mortgage servicing rights (MSRs) are recognized based on the fair value of the servicing rights on the date the corresponding mortgage loans are sold. An estimate of the fair value of the Company's MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rates, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income.

The Company has recorded MSR's related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. MSR's are included in other assets on the accompanying consolidated balance sheets.

The Company evaluates MSR's for impairment on a quarterly basis. Impairment is determined by stratifying MSR's into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSR's exceeds fair value, a valuation allowance is established. The valuation allowance is adjusted as the fair value changes. Changes in the valuation allowance are recognized in earnings as a component of mortgage lending income.

Table of Contents

The following table details the changes in amortized MSR's and the related valuation allowance for the respective periods.

Quarter ended September 30, 2015 **Nine Months Ended September 30, 2014***(Dollars in thousands)*

	2015	2014	2015	2014
MSR's, net:				
Beginning balance	\$ 2,359	\$ 2,346	\$ 2,388	\$ 2,350
Additions, net	174	168	440	371
Amortization expense	(171)	(89)	(505)	(253)
Decrease (increase) in valuation allowance	13	12	52	(31)
Ending balance	\$ 2,375	\$ 2,437	\$ 2,375	\$ 2,437

Valuation allowance included in MSR's, net:

Beginning of period	\$ 14	\$ 43	\$ 53	\$
End of period	1	31	1	31

Fair value of amortized MSR's:

Beginning of period	\$ 3,014	\$ 3,228	\$ 3,238	\$ 3,452
End of period	3,052	3,314	3,052	3,314

NOTE 7: DERIVATIVE INSTRUMENTS

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

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

A summary of the Company's interest rate swap agreements at September 30, 2015 and December 31, 2014 is presented below.

		Other	Other
		Assets Estimated	Liabilities Estimated
<i>(Dollars in thousands)</i>	Notional	Fair Value	Fair Value
September 30, 2015:			
Pay fixed / receive variable	\$ 4,404		524
Pay variable / receive fixed	4,404	524	
Total interest rate swap agreements	\$ 8,808	524	524
December 31, 2014:			
Pay fixed / receive variable	\$ 4,667		634
Pay variable / receive fixed	4,667	634	
Total interest rate swap agreements	\$ 9,334	634	634

Table of Contents

NOTE 8: FAIR VALUE

Fair Value Hierarchy

Fair value is defined by ASC 820, *Fair Value Measurements and Disclosures*, as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for an asset or liability at the measurement date. GAAP establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs to the valuation methodology are unobservable and reflect the Company's own assumptions about the inputs market participants would use in pricing the asset or liability.

Level changes in fair value measurements

Transfers between levels of the fair value hierarchy are generally recognized at the end of the reporting period. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company's financial assets and liabilities generally is such that transfers in and out of any level are expected to be infrequent. For the nine months ended September 30, 2015, there were no transfers between levels and no changes in valuation techniques for the Company's financial assets and liabilities.

Assets and liabilities measured at fair value on a recurring basis

Securities available-for-sale

Fair values of securities available for sale were primarily measured using Level 2 inputs. For these securities, the Company obtains pricing from third party pricing services. These third party pricing services consider observable data that may include broker/dealer quotes, market spreads, cash flows, benchmark yields, reported trades for similar securities, market consensus prepayment speeds, credit information, and the securities' terms and conditions. On a quarterly basis, management reviews the pricing received from the third party pricing services for reasonableness given current market conditions. As part of its review, management may obtain non-binding third party broker quotes to validate the fair value measurements. In addition, management will periodically submit pricing provided by the third party pricing services to another independent valuation firm on a sample basis. This independent valuation firm will compare the price provided by the third party pricing service with its own price and will review the significant assumptions and valuation methodologies used with management.

Interest rate swap agreements

The carrying amount of interest rate swap agreements was included in other assets and accrued expenses and other liabilities on the accompanying consolidated balance sheets. The fair value measurements for our interest rate swap

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

Table of Contents

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of September 30, 2015 and December 31, 2014, respectively, by caption, on the accompanying consolidated balance sheets by ASC 820 valuation hierarchy (as described above).

	Amount	Quoted Prices in	Significant	
		Active Markets	Other	Significant
		for	Observable	Unobservable
		Identical Assets	Inputs	Inputs
		(Level 1)	(Level 2)	(Level 3)
<i>(Dollars in thousands)</i>				
September 30, 2015:				
Securities available-for-sale:				
Agency obligations	\$ 60,555		60,555	
Agency RMBS	117,303		117,303	
State and political subdivisions	72,284		72,284	
Total securities available-for-sale	250,142		250,142	
Other assets ⁽¹⁾	524		524	
Total assets at fair value	\$ 250,666		250,666	
Other liabilities⁽¹⁾	\$ 524		524	
Total liabilities at fair value	\$ 524		524	
December 31, 2014:				
Securities available-for-sale:				
Agency obligations	\$ 60,249		60,249	
Agency RMBS	135,043		135,043	
State and political subdivisions	72,311		72,311	

Total securities available-for-sale	267,603	267,603
Other assets ⁽¹⁾	634	634
Total assets at fair value	\$ 268,237	268,237
Other liabilities ⁽¹⁾	\$ 634	634
Total liabilities at fair value	\$ 634	634

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

Assets and liabilities measured at fair value on a nonrecurring basis

Loans held for sale

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

Impaired Loans

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

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

Table of Contents*Other real estate owned*

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

Mortgage servicing rights, net

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

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of September 30, 2015 and December 31, 2014, respectively, by caption, on the accompanying consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above):

(Dollars in thousands)

Carrying	Quoted Prices in	Other	Significant
Amount	Active Markets	Observable	Unobservable
	for	Inputs	Inputs
	Identical Assets	(Level 2)	(Level 3)

(Level 1)

September 30, 2015:			
Loans held for sale	\$	3,551	3,551
Loans, net ⁽¹⁾		3,445	3,445
Other real estate owned		278	278
Other assets ⁽²⁾		2,375	2,375
Total assets at fair value	\$	9,649	3,551 6,098
December 31, 2014:			
Loans held for sale	\$	1,974	1,974
Loans, net ⁽¹⁾		3,077	3,077
Other real estate owned		534	534
Other assets ⁽²⁾		2,388	2,388
Total assets at fair value	\$	7,973	1,974 5,999

⁽¹⁾Loans considered impaired under ASC 310-10-35, *Receivables*. This amount reflects the recorded investment in

impaired loans, net of any related allowance for loan losses.

⁽²⁾Represents MSRs, net, carried at lower of cost or estimated fair value.

Table of Contents**Quantitative Disclosures for Level 3 Fair Value Measurements**

At September 30, 2015, the Company had no Level 3 assets measured at fair value on a recurring basis. For Level 3 assets measured at fair value on a non-recurring basis at September 30, 2015, the significant unobservable inputs used in the fair value measurements are presented below.

<i>(Dollars in thousands)</i>	Carrying			Weighted
	Amount	Valuation Technique	Significant Unobservable Input	Average
				of Input
Nonrecurring:				
Impaired loans	\$ 3,445	Appraisal	Appraisal discounts (%)	24.4%
Other real estate owned	278	Appraisal	Appraisal discounts (%)	12.9%
Mortgage servicing rights, net	2,375	Discounted cash flow	Prepayment speed or CPR (%)	10.2%
			Discount rate (%)	10.0%

Fair Value of Financial Instruments

ASC 825, *Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow analyses. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent markets and should not be considered representative of the liquidation value of the Company's financial instruments, but rather are a good-faith estimate of the fair value of financial instruments held by the Company. ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

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

Loans, net

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

exit-price approach. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

Loans held for sale

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

Time Deposits

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

Long-term debt

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

Table of Contents

The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company's financial instruments at September 30, 2015 and December 31, 2014 are presented below. This table excludes financial instruments for which the carrying amount approximates fair value. Financial assets for which fair value approximates carrying value included cash and cash equivalents. Financial liabilities for which fair value approximates carrying value included noninterest-bearing demand deposits, interest-bearing demand deposits, and savings deposits due to these products having no stated maturity. In addition, financial liabilities for which fair value approximates carrying value included overnight borrowings such as federal funds purchased and securities sold under agreements to repurchase.

	Carrying	Estimated	Fair Value Hierarchy		
			Level 1	Level 2	Level 3
(Dollars in thousands)	amount	fair value	inputs	inputs	Inputs
September 30, 2015:					
Financial Assets:					
Loans, net (1)	\$ 417,445	\$ 426,383	\$	\$	\$ 426,383
Loans held for sale	3,551	3,646		3,646	
Financial Liabilities:					
Time Deposits	\$ 225,167	\$ 226,197	\$	\$ 226,197	\$
Long-term debt	7,217	7,217		7,217	
December 31, 2014:					
Financial Assets:					
Loans, net (1)	\$ 398,118	\$ 407,839	\$	\$	\$ 407,839
Loans held for sale	1,974	2,044		2,044	
Financial Liabilities:					
Time Deposits	\$ 249,126	\$ 251,365	\$	\$ 251,365	\$
Long-term debt	12,217	12,558		12,558	

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

Table of Contents

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

General

The following discussion and analysis is designed to provide a better understanding of various factors related to the results of operations and financial condition of Auburn National Bancorporation, Inc. (the Company) and its wholly owned subsidiary, AuburnBank (the Bank). This discussion is intended to supplement and highlight information contained in the accompanying unaudited condensed consolidated financial statements and related notes for the quarters and nine months ended September 30, 2015 and 2014, as well as the information contained in our annual report on Form 10-K for the year ended December 31, 2014 and our quarterly reports on Form 10-Q for the quarters ended March 31, 2015 and June 30, 2015.

Special Notice Regarding Forward-Looking Statements

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

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

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as may, will, anticipate, assume, show, indicate, would, believe, contemplate, expect, estimate, continue, plan, point to, project, could, similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation:

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

governmental monetary and fiscal policies;

legislative and regulatory changes, including changes in banking, securities, and tax laws, regulations and rules and their application by our regulators, including capital and liquidity requirements, and changes in the scope and cost of FDIC insurance;

changes in accounting policies, rules, and practices;

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

changes in borrower credit risks and payment behaviors;

changes in the availability and cost of credit and capital in the financial markets, and the types of instruments that may be included as capital for regulatory purposes;

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

Table of Contents

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

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

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

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

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

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

the other factors and information in this report and other filings that we make with the SEC under the Exchange Act, including our Annual Report on Form 10-K for the year ended December 31, 2014 and subsequent quarterly and current reports. See Part II, Item 1A. **RISK FACTORS** .

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

Business

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

Summary of Results of Operations

Quarter ended September 30, Nine Months Ended September 30,

<i>(Dollars in thousands, except per share amounts)</i>	2015	2014	2015	2014
Net interest income (a)	\$ 6,011	\$ 5,769	\$ 17,995	\$ 16,928
Less: tax-equivalent adjustment	341	321	1,014	957
Net interest income (GAAP)	5,670	5,448	16,981	15,971
Noninterest income	1,056	1,017	3,544	2,854
Total revenue	6,726	6,465	20,525	18,825
Provision for loan losses	200	300	200	(100)
Noninterest expense	3,892	3,584	12,235	11,324
Income tax expense	724	709	2,168	2,049
Net earnings	\$ 1,910	\$ 1,872	\$ 5,922	\$ 5,552
Basic and diluted earnings per share	\$ 0.52	\$ 0.51	\$ 1.63	\$ 1.52

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

Table of Contents**Financial Summary**

The Company's net earnings were \$5.9 million for the first nine months of 2015, compared to \$5.6 million for the first nine months of 2014. Basic and diluted earnings per share were \$1.63 per share for the first nine months of 2015, compared to \$1.52 per share for the first nine months of 2014.

Net interest income (tax-equivalent) was \$18.0 million for the first nine months of 2015, an increase of 6% compared to the first nine months of 2014. The increase reflects management's efforts to increase earnings by shifting the Company's asset mix through loan growth, focusing on deposit pricing, and repaying higher-cost wholesale funding. Net interest income (tax-equivalent) for the first nine months of 2015 included \$0.2 million in recoveries of interest related to payoffs received on two loans that were previously impaired. Excluding the impact of these interest recoveries, net interest income (tax-equivalent) would have been \$17.8 million for the first nine months of 2015, an increase of 5% compared to the first nine months of 2014. Average loans were \$406.3 million in the first nine months of 2015, an increase of \$24.4 million or 6%, from the first nine months of 2014. Average deposits were \$706.8 million in the first nine months of 2015, an increase of \$26.2 million or 4%, from the first nine months of 2014.

The Company recorded \$0.2 million in provision for loan losses for the first nine months of 2015, compared to a negative provision of \$0.1 million for the first nine months of 2014. Provision expense reflects the absolute level of loans, loan growth, the credit quality of the loan portfolio, and the amount of net charge-offs.

Noninterest income was \$3.5 million for the first nine months of 2015, compared to \$2.9 million in the first nine months of 2014. The increase was primarily due to an increase in income from bank-owned life insurance of \$0.3 million related to death benefits recognized in the first nine months of 2015 and an increase in net securities gains (losses) of \$0.5 million due to losses realized on the sale of securities in the first nine months of 2014. These increases were partially offset by a decrease in mortgage lending of \$0.1 million as servicing fees, net of related amortization expense declined.

Noninterest expense was \$12.2 million in the first nine months of 2015, compared to \$11.3 million in the first nine months of 2014. The increase was primarily due to prepayment penalties on long-term debt of \$0.4 million incurred in the first nine months of 2015 when the company repaid \$5.0 million of long-term debt with an interest rate of 3.59%, an increase in OREO expense, net of \$0.2 million due to gains realized on the sale of certain OREO properties in the first nine months of 2014, and an increase in other noninterest expense of \$0.2 million.

Income tax expense was \$2.2 million for the first nine months of 2015, compared to \$2.0 million for the first nine months of 2014. The Company's income tax expense for the first nine months of 2015 reflects an effective income tax rate of 26.80%, compared to 26.96% for the first nine months of 2014. The Company's effective income tax rate is principally impacted by tax-exempt earnings from the Company's investments in municipal securities and bank-owned life insurance.

In the first nine months of 2015, the Company paid cash dividends of \$2.4 million, or \$0.66 per share. The Company's balance sheet remains well capitalized under current regulatory guidelines with a total risk-based capital ratio of 17.33% and a Tier 1 leverage ratio of 10.37% at September 30, 2015.

In the third quarter of 2015, net earnings were \$1.9 million, or \$0.52 per share, compared to \$1.9 million, or \$0.51 per share, for the third quarter of 2014. Net interest income (tax-equivalent) was \$6.0 million for the third quarter of 2015, an increase of 4% compared to the third quarter of 2014. The Company recorded \$0.2 million in provision for loan losses in the third quarter of 2015 compared to \$0.3 million in third quarter 2014. Noninterest income was \$1.1 million in the third quarter of 2015, compared to \$1.0 million in the third quarter of 2014. Noninterest expense was

\$3.9 million in the third quarter of 2015, compared to \$3.6 million in the third quarter of 2014. The increase was primarily due to an increase in OREO expense, net due to gains realized on the sale of certain OREO properties in the third quarter of 2014. Income tax expense was approximately \$0.7 million for the third quarter of 2015 and 2014. The Company's effective tax rate for the third quarter of 2015 was 27.49%, compared to 27.47% in the third quarter of 2014.

Table of Contents

CRITICAL ACCOUNTING POLICIES

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses, our assessment of other-than-temporary impairment, recurring and non-recurring fair value measurements, the valuation of other real estate owned, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates, and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred, which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

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

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

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

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

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

loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for each loan segment. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At September 30, 2015 and December 31, 2014, and for the periods then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management's estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic

Table of Contents

conditions, changes in lending personnel experience, changes in lending policies or procedures, and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. During 2014, the Company implemented certain refinements to its allowance for loan losses methodology in order to better capture the effects of the most recent economic cycle on the Company's loan loss experience. Beginning with the quarter ended June 30, 2014, the Company calculated average losses for all loan segments using a rolling 20 quarter historical period and continues to use this methodology.

Prior to June 30, 2014, the Company calculated average losses for all loan segments using a rolling 8 quarter historical period (except for the commercial real estate loan segment, which used a 6 quarter historical period). If the Company continued to calculate average losses for all loan segments other than commercial real estate using a rolling 8 quarter historical period and for the commercial real estate segment using a rolling 6 quarter historical period, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$1.0 million at June 30, 2014. Other than the changes discussed above, the Company has not made any material changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

Assessment for Other-Than-Temporary Impairment of Securities

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

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

Fair Value Determination

U.S. GAAP requires management to value and disclose certain of the Company's assets and liabilities at fair value, including investments classified as available-for-sale and derivatives. ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S.

GAAP and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 8, Fair Value, of the consolidated financial statements that accompany this report.

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

Table of Contents

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

Other Real Estate Owned

Other real estate owned (OREO), consists of properties obtained through foreclosure or in satisfaction of loans and is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired, with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal of OREO are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other OREO.

Deferred Tax Asset Valuation

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of taxable income over the last three years and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at September 30, 2015. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

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

	Nine Months Ended September 30,			
	2015		2014	
	Average	Yield/	Average	Yield/
<i>(Dollars in thousands)</i>	Balance	Rate	Balance	Rate
Loans and loans held for sale	\$ 408,954	5.01%	\$ 384,370	5.05%
Securities - taxable	189,750	2.06%	210,680	2.26%
Securities - tax-exempt	68,549	5.82%	61,500	6.12%

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Total securities	258,299	3.06%	272,180	3.13%
Federal funds sold	59,639	0.22%	54,866	0.19%
Interest bearing bank deposits	27,589	0.23%	7,350	0.45%
Total interest-earning assets	754,481	3.79%	718,766	3.90%
Deposits:				
NOW	114,973	0.30%	105,734	0.32%
Savings and money market	212,300	0.39%	190,223	0.51%
Certificates of deposits less than \$100,000	92,510	1.04%	102,755	1.17%
Certificates of deposits and other time deposits of \$100,000 or more	142,575	1.44%	156,833	1.58%
Total interest-bearing deposits	562,358	0.75%	555,545	0.90%
Short-term borrowings	3,758	0.50%	3,605	0.52%
Long-term debt	8,645	3.45%	12,217	3.43%
Total interest-bearing liabilities	574,761	0.79%	571,367	0.95%
Net interest income and margin (tax-equivalent)	\$ 17,995	3.19%	\$ 16,928	3.15%

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

Net interest income (tax-equivalent) was \$18.0 million for the first nine months of 2015, compared to \$16.9 million for the first nine months of 2014. This increase reflects management's efforts to increase earnings by shifting the Company's asset mix through loan growth, focusing on deposit pricing, and repaying higher-cost wholesale funding. Net interest income (tax-equivalent) for the first nine months of 2015 included \$0.2 million in recoveries of interest related to payoffs received on two loans that were previously impaired. Excluding the impact of these interest recoveries, net interest income (tax-equivalent) would have been \$17.8 million for the first nine months of 2015, an increase of 5% compared to the first nine months of 2014.

The tax-equivalent yield on total interest-earning assets decreased by 11 basis points in the first nine months of 2015 from the first nine months of 2014 to 3.79%. This decrease was primarily due to declining yields on securities and increased pricing competition for quality loan opportunities in our markets, which has limited the Company's ability to increase yields on new and renewed loans.

The cost of total interest-bearing liabilities decreased 16 basis points in the first nine months of 2015 from the first nine months of 2014 to 0.79%. The net decrease was largely a result of the continued shift in our funding mix, as we increased our lower-cost interest bearing demand deposits (NOW accounts), and savings and money market accounts and concurrently reduced balances of higher-cost certificates of deposits and long-term debt.

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

Provision for Loan Losses

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that management believes, based on its processes and estimates, should be adequate to provide for the probable losses on outstanding loans. The Company recorded \$0.2 million in provision for loan losses for the first nine months of 2015, compared to a negative provision of \$0.1 million for the first nine months of 2014. Provision expense reflects the absolute level of loans, loan growth, the credit quality of the loan portfolio, and the amount of net charge-offs.

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes should be appropriate to adequately cover its estimate of probable losses in the loan portfolio. The Company's allowance for loan losses as a percentage of total loans was 1.21% at September 30, 2015, compared to 1.20% at December 31, 2014. While the policies and procedures used to estimate the allowance for loan losses, as well as the resulting provision for loan losses charged to operations, are considered adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgments and are therefore approximate and imprecise. Factors beyond our control (such as conditions in the local and national economy, local real estate markets, or industry) may have a material adverse effect on our asset quality and the adequacy of our allowance for loan losses resulting in significant increases in the provision for loan losses.

Noninterest Income

Quarter ended September 30, 2015 **Three Months Ended September 30, 2015**

<i>(Dollars in thousands)</i>	2015	2014	2015	2014
Service charges on deposit accounts	\$ 209	\$ 228	\$ 624	\$ 660
Mortgage lending income	362	534	1,153	1,268
Bank-owned life insurance	116	124	629	375
Securities gains (losses), net	11	(235)		