

AUBURN NATIONAL BANCORPORATION, INC  
Form 10-K  
March 10, 2016  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

**☐ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the fiscal year ended December 31, 2015**

**OR**

**☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 0-26486**

**Auburn National Bancorporation, Inc.**

(Exact name of registrant as specified in charter)

Delaware  
(State or other jurisdiction  
of incorporation)

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

100 N. Gay Street, Auburn, Alabama  
(Address of principal executive offices)

36830  
(Zip Code)

Registrant's telephone number, including area code: (334) 821-9200

**Securities registered pursuant to Section 12 (b) of the Act:**

<b>Title of Each Class</b>	<b>Name of Exchange on which Registered</b>
Common Stock, par value \$0.01	Nasdaq Global Market

**Securities registered to Section 12(g) of the Act:** None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 (§ 232.405 of this chapter) 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input checked="" type="checkbox"/>
--------------------------------------------------	--------------------------------------------	------------------------------------------------	---------------------------------------------------------------

(Do not check if a smaller reporting company)

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity as of the last business day of the registrant's most recently completed second fiscal quarter: \$59,782,523 as of June 30, 2015.

#### APPLICABLE ONLY TO CORPORATE REGISTRANTS

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 3,643,478 shares of common stock as of March 9, 2016.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Annual Meeting of Shareholders, scheduled to be held May 10, 2016, are incorporated by reference into Part II, Item 5 and Part III of this Form 10-K.

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**PART I**

**SPECIAL CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Various of the statements made herein under the captions Management's Discussion and Analysis of Financial Condition and Results of Operations, Quantitative and Qualitative Disclosures about Market Risk, Risk Factors and elsewhere, are forward-looking statements within the meaning and protections of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act).

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

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

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

governmental monetary and fiscal policies;

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

changes in accounting policies, rules and practices;

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

changes in borrower credit risks and payment behaviors;

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

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

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

the failure of assumptions and estimates underlying the establishment of reserves for possible loan losses and other estimates;

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

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

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

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

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

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

other factors and risks described under "Risk Factors" herein and in any of our subsequent reports that we make with the Securities and Exchange Commission (the "Commission" or "SEC") under the Exchange Act.

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

## **ITEM 1. BUSINESS**

Auburn National Bancorporation, Inc. (the "Company") is a bank holding company registered with the Board of Governors of the Federal Reserve System (the "Federal Reserve") under the Bank Holding Company Act of 1956, as amended (the "BHC Act"). The Company was incorporated in Delaware in 1990, and in 1994 it succeeded its Alabama predecessor as the bank holding company controlling AuburnBank, an Alabama state member bank with its principal office in Auburn, Alabama (the "Bank"). The Company and its predecessor have controlled the Bank since 1984. As a bank holding company, the Company may diversify into a broader range of financial services and other business activities than currently are permitted to the Bank under applicable laws and regulations. The holding company structure also provides greater financial and operating flexibility than is presently permitted to the Bank.

The Bank has operated continuously since 1907 and currently conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank has been a member of the Federal Reserve System since April 1995. The Bank's primary regulators are the Federal Reserve and the Alabama Superintendent of Banks (the "Alabama Superintendent"). The Bank has been a member of the Federal Home Loan Bank of Atlanta (the "FHLB") since 1991.

### **General**

The Company's business is conducted primarily through the Bank and its subsidiaries. Although it has no immediate plans to conduct any other business, the Company may engage directly or indirectly in a number of activities that the Federal Reserve has determined to be so closely related to banking or managing or controlling banks as to be a proper

incident thereto.

The Company's principal executive offices are located at 100 N. Gay Street, Auburn, Alabama 36830, and its telephone number at such address is (334) 821-9200. The Company maintains an Internet website at [www.auburnbank.com](http://www.auburnbank.com). The Company's website and the information appearing on the website are not included or incorporated in, and are not part of, this report. The Company files annual, quarterly and current reports, proxy statements, and other information with the SEC. You may read and copy any document we file with the SEC at the SEC's public reference room at 100 F Street, N.E., Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for more information on the operation of the public reference rooms. The SEC maintains an Internet site at [www.sec.gov](http://www.sec.gov) that contains reports, proxy, and other information, where SEC filings are available to the public free of charge.

The Company directly owns all the common equity in Auburn National Bancorporation Capital Trust I, a Delaware statutory trust, which was formed in 2003 for the purpose of issuing \$7.0 million of floating rate capital securities, which are included in our Tier 1 capital.

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### **Services**

The Bank offers checking, savings, transaction deposit accounts and certificates of deposit, and is an active residential mortgage lender in its primary service area. The Bank's primary service area includes the cities of Auburn and Opelika, Alabama and nearby surrounding areas in East Alabama, primarily in Lee County. The Bank also offers commercial, financial, agricultural, real estate construction and consumer loan products and other financial services. The Bank is one of the largest providers of automated teller services in East Alabama and operates ATM machines in 14 locations in its primary service area. The Bank offers Visa® Checkcards, which are debit cards with the Visa logo that work like checks but can be used anywhere Visa is accepted, including ATMs. The Bank's Visa Checkcards can be used internationally through the Cirrus® network. The Bank offers online banking and bill payment services through its Internet website, [www.auburnbank.com](http://www.auburnbank.com)

### **Competition**

The banking business in East Alabama, including Lee County, is highly competitive with respect to loans, deposits, and other financial services. The area is dominated by a number of regional and national banks and bank holding companies that have substantially greater resources, and numerous offices and affiliates operating over wide geographic areas. The Bank competes for deposits, loans and other business with these banks, as well as with credit unions, mortgage companies, insurance companies, and other local and nonlocal financial institutions, including institutions offering services through the mail, by telephone and over the Internet. As more and different kinds of businesses enter the market for financial services, competition from nonbank financial institutions may be expected to intensify further.

Among the advantages that larger financial institutions have over the Bank are their ability to finance extensive advertising campaigns, to diversify their funding sources, and to allocate and diversify their assets among loans and securities of the highest yield in locations with the greatest demand. Many of the major commercial banks or their affiliates operating in the Bank's service area offer services which are not presently offered directly by the Bank and they typically have substantially higher lending limits than the Bank.

Banks also have experienced significant competition for deposits from mutual funds, insurance companies and other investment companies and from money center banks' offerings of high-yield investments and deposits. Certain of these competitors are not subject to the same regulatory restrictions as the Bank.

### **Selected Economic Data**

Lee County's population was estimated to be 154,255 in 2014, and has increased approximately 10.0% from 2010 to 2014. The largest employers in the area are Auburn University, East Alabama Medical Center, a Wal-Mart Distribution Center, Mando America Corporation, and Briggs & Stratton. Auto manufacturing is of increasing importance along Interstate Highway 85 to the east and west of Auburn. Kia Motors has a large automobile factory in nearby West Point, Georgia, and Hyundai Motors has a large automobile factory in Montgomery, Alabama.

### **Loans and Loan Concentrations**

The Bank makes loans for commercial, financial and agricultural purposes, as well as for real estate mortgages, real estate acquisition, construction and development and consumer purposes. While there are certain risks unique to each type of lending, management believes that there is more risk associated with commercial, real estate acquisition, construction and development, agricultural and consumer lending than with residential real estate mortgage loans. To help manage these risks, the Bank has established underwriting standards used in evaluating each extension of credit



on an individual basis, which are substantially similar for each type of loan. These standards include a review of the economic conditions affecting the borrower, the borrower's financial strength and capacity to repay the debt, the underlying collateral and the borrower's past credit performance. We apply these standards at the time a loan is made and monitor them periodically throughout the life of the loan. See [Lending Practices](#) for a discussion of regulatory guidance on commercial real estate lending.

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The Bank has loans outstanding to borrowers in all industries within its primary service area. Any adverse economic or other conditions affecting these industries would also likely have an adverse effect on the local workforce, other local businesses, and individuals in the community that have entered into loans with the Bank. The auto manufacturing business and its suppliers have positively affected our local economy, but automobile manufacturing is cyclical and adversely affected by increases in interest rates. Decreases in automobile sales, including adverse changes due to interest rate increases, could adversely affect the Kia and Hyundai plants and their suppliers' local spending and employment, and could adversely affect economic conditions in the markets we serve. However, management believes that due to the diversified mix of industries located within the Bank's primary service area, adverse changes in one industry may not necessarily affect other area industries to the same degree or within the same time frame. The Bank's primary service area also is subject to both local and national economic conditions and fluctuations. While most loans are made within our primary service area, some residential mortgage loans are originated outside the primary service area, and the Bank from time to time has purchased loan participations from outside its primary service area.

## **Employees**

At December 31, 2015, the Company and its subsidiaries had 157 full-time equivalent employees, including 35 officers.

## **Statistical Information**

Certain statistical information is included in response to Item 7 of this Annual Report on Form 10-K. Certain statistical information is also included in response to Item 6, Item 7A and Item 8 of this Annual Report on Form 10-K.

## **SUPERVISION AND REGULATION**

The Company and the Bank are extensively regulated under federal and state laws applicable to financial institutions. The supervision, regulation and examination of the Company and the Bank and their respective subsidiaries by the bank regulatory agencies are primarily intended to maintain the safety and soundness of financial institutions and the federal deposit insurance system, as well as the protection of depositors, rather than holders of Company capital stock and other securities. Any change in applicable law or regulation may have a material effect on the Company's business. The following discussion is qualified in its entirety by reference to the particular statutory and regulatory provisions referred to below.

### **Bank Holding Company Regulation**

The Company, as a bank holding company, is subject to supervision, regulation and examination by the Federal Reserve under the BHC Act. Bank holding companies are generally limited to the business of banking, managing or controlling banks, and other activities that the Federal Reserve determines to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Company is required to file with the Federal Reserve periodic reports and such other information as the Federal Reserve may request. The Federal Reserve examines the Company, and may examine its subsidiaries. The State of Alabama currently does not regulate bank holding companies.

The BHC Act requires prior Federal Reserve approval for, among other things, the acquisition by a bank holding company of direct or indirect ownership or control of more than 5% of the voting shares or substantially all the assets of any bank, or for a merger or consolidation of a bank holding company with another bank holding company. With certain exceptions, the BHC Act prohibits a bank holding company from acquiring direct or indirect ownership or

control of voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in any activity other than banking or managing or controlling banks or performing services for its authorized subsidiary. A bank holding company may, however, engage in or acquire an interest in a company that engages in activities that the Federal Reserve has determined by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

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Bank holding companies that are and remain well-capitalized and well-managed, as defined in Federal Reserve Regulation Y, and have and whose insured depository institution subsidiaries maintain satisfactory or better ratings under the Community Reinvestment Act of 1977, (the CRA ), may elect to become financial holding companies. Financial holding companies and their subsidiaries are permitted to acquire or engage in previously impermissible activities such as insurance underwriting, securities underwriting, travel agency activities, broad insurance agency activities, merchant banking and other activities that the Federal Reserve determines to be financial in nature or complementary thereto. In addition, under the BHC's merchant banking authority and Federal Reserve regulations, financial holding companies are authorized to invest in companies that engage in activities that are not financial in nature, as long as the financial holding company makes its investment with the intention of limiting the terms of its investment, does not manage the company on a day-to-day basis, and the investee company does not cross-market with any depository institutions controlled by the financial holding company. Financial holding companies continue to be subject to Federal Reserve supervision, regulation and examination, but the Gramm-Leach-Bliley Act of 1999 (the GLB Act ) applies the concept of functional regulation to the activities conducted by subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. While the Company has not elected to become a financial holding company, in order to exercise the broader activity powers provided by the GLB Act, it may elect to do so in the future.

The BHC Act permits acquisitions of banks by bank holding companies, subject to various restrictions, including deposit share limits, and that the acquirer be well capitalized and well managed . Under the Alabama Banking Code, with the prior approval of the Alabama Superintendent, an Alabama bank may acquire and operate one or more banks in other states pursuant to a transaction in which the Alabama bank is the surviving bank. In addition, one or more Alabama banks may enter into a merger transaction with one or more out-of-state banks, and an out-of-state bank resulting from such transaction may continue to operate the acquired branches in Alabama. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act ), banks, including Alabama banks, may branch anywhere in the United States.

The Company is a legal entity separate and distinct from the Bank. Various legal limitations restrict the Bank from lending or otherwise supplying funds to the Company. The Company and the Bank are subject to Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W thereunder. Section 23A defines covered transactions, which include extensions of credit, and limits a bank's covered transactions with any affiliate to 10% of such bank's capital and surplus. All covered and exempt transactions between a bank and its affiliates must be on terms and conditions consistent with safe and sound banking practices, and banks and their subsidiaries are prohibited from purchasing low-quality assets from the bank's affiliates. Finally, Section 23A requires that all of a bank's extensions of credit to its affiliates be appropriately secured by permissible collateral, generally United States government or agency securities. Section 23B of the Federal Reserve Act generally requires covered and other transactions among affiliates to be on terms and under circumstances, including credit standards, that are substantially the same as or at least as favorable to the bank or its subsidiary as those prevailing at the time for similar transactions with unaffiliated companies.

Federal Reserve policy, as well as the Federal Deposit Insurance Act, as amended by the Dodd-Frank Act, requires a bank holding company to act as a source of financial and managerial strength to its bank subsidiaries and to take measures to preserve and protect its bank subsidiaries in situations where additional investments in a bank subsidiary may not otherwise be warranted. In the event an FDIC-insured subsidiary becomes subject to a capital restoration plan with its regulators, the parent bank holding company is required to guarantee performance of such plan up to 5% of the bank's assets, and such guarantee is given priority in bankruptcy of the bank holding company. In addition, where a bank holding company has more than one bank or thrift subsidiary, each of the bank holding company's subsidiary depository institutions are responsible for any losses to the FDIC's Deposit Insurance Fund ( DIF ) as a result of an affiliated depository institution's failure. As a result, a bank holding company may be required to loan money to a bank

subsidiary in the form of subordinate capital notes or other instruments which qualify as capital under bank regulatory rules. However, any loans from the holding company to such subsidiary banks likely will be unsecured and subordinated to such bank's depositors and to other creditors of the bank. See Capital.

Public Law 113-250 was enacted on December 18, 2014. This law directed the Federal Reserve to publish, within six months, changes to the Federal Reserve's Small Bank Holding Company Policy Statement on Assessment of Financial and Managerial Factors (the Small BHC Policy) to expand the coverage of the Small BHC Policy to include thrift holding companies and increase the size of small for qualifying bank and thrift holding companies from \$500 million to up to \$1 billion of pro forma consolidated assets. The Federal Reserve implemented changes to its Small BHC Policy effective May 15, 2015. The Company believes that it currently would qualify for treatment as a small bank holding company under the revised Small BHC Policy, including the related qualitative standards, except that the Company's common stock is registered with the Securities Exchange Commission. As a result, unless and until the Company qualifies under the Small BHC Policy, the Company's capital adequacy will continue to be evaluated on a consolidated basis. See Capital.

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### **Bank Regulation**

The Bank is subject to supervision, regulation and examination by the Federal Reserve and the Alabama Superintendent, which monitor all areas of the operations of the Bank, including reserves, loans, mortgages, issuances and redemption of capital securities, payment of dividends, establishment of branches, capital adequacy and compliance with laws. The Bank is a member of the FDIC and, as such, its deposits are insured by the FDIC to the maximum extent provided by law. See FDIC Insurance Assessments.

Alabama law permits statewide branching by banks. The powers granted to Alabama-chartered banks by state law include certain provisions designed to provide such banks competitive equality with national banks.

In 2007, the Alabama legislature amended the Alabama Banking Code to, among other things; strengthen the regulatory and enforcement authority of the Alabama State Banking Department and the Alabama Superintendent of Banks.

The Federal Reserve has adopted the Federal Financial Institutions Examination Council's (FFIEC) updated rating system, which assigns each financial institution a confidential composite CAMELS rating based on an evaluation and rating of six essential components of an institution's financial condition and operations: **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to market risk, as well as the quality of risk management practices. For most institutions, the FFIEC has indicated that market risk primarily reflects exposures to changes in interest rates. When regulators evaluate this component, consideration is expected to be given to: management's ability to identify, measure, monitor and control market risk; the institution's size; the nature and complexity of its activities and its risk profile; and the adequacy of its capital and earnings in relation to its level of market risk exposure. Market risk is rated based upon, but not limited to, an assessment of the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices or equity prices; management's ability to identify, measure, monitor and control exposure to market risk; and the nature and complexity of interest rate risk exposure arising from non-trading positions.

The GLB Act and related regulations require banks and their affiliated companies to adopt and disclose privacy policies, including policies regarding the sharing of personal information with third parties. The GLB Act also permits bank subsidiaries to engage in financial activities similar to those permitted to financial holding companies.

### **Community Reinvestment Act and Consumer Laws**

The Bank is subject to the provisions of the CRA and the Federal Reserve's regulations thereunder. Under the CRA, all banks and thrifts have a continuing and affirmative obligation, consistent with their safe and sound operation, to help meet the credit needs for their entire communities, including low- and moderate-income neighborhoods. The CRA requires a depository institution's primary federal regulator, in connection with its examination of the institution, to assess the institution's record of assessing and meeting the credit needs of the communities served by that institution, including low- and moderate-income neighborhoods. The bank regulatory agency's assessment of the institution's record is made available to the public. Further, such assessment is required of any institution which has applied to: (i) charter a national bank; (ii) obtain deposit insurance coverage for a newly-chartered institution; (iii) establish a new branch office that accepts deposits; (iv) relocate an office; or (v) merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution. In the case of a bank holding company applying for approval to acquire a bank or other bank holding company, the Federal Reserve will assess the records of each subsidiary depository institution of the applicant bank holding company, and such records may be the basis for denying the application. A less than satisfactory CRA rating will slow, if not preclude, acquisitions, and branch and other expansion activities and may prevent a company from becoming a financial holding company.

As a result of the GLB Act, CRA agreements with private parties must be disclosed and annual CRA reports must be made to a bank's primary federal regulator. No new activities authorized under the GLB Act may be commenced by a bank holding company or by a bank financial subsidiary if any of its bank subsidiaries received less than a satisfactory CRA rating in its latest CRA examination. The federal CRA regulations require that evidence of discriminatory, illegal or abusive lending practices be considered in the CRA evaluation.

The Bank is also subject to, among other things, the provisions of the Equal Credit Opportunity Act (the ECOA ) and the Fair Housing Act (the FHA ), both of which prohibit discrimination based on race or color, religion, national origin, sex and familial status in any aspect of a consumer or commercial credit or residential real estate transaction. The Department of Justice (the DOJ ), and the federal bank regulatory agencies have issued an Interagency Policy Statement

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on Discrimination in Lending to provide guidance to financial institutions in determining whether discrimination exists, how the agencies will respond to lending discrimination, and what steps lenders might take to prevent discriminatory lending practices. The DOJ has increased its efforts to prosecute what it regards as violations of the ECOA and FHA, and the fair lending laws, generally.

The federal bank regulators have updated their guidance several times on overdrafts, including overdrafts incurred at automated teller machines and point of sale terminals. Overdrafts have become a focus of the federal Consumer Financial Protection Bureau ( CFPB ). Among other things, the federal regulators require banks to monitor accounts and to limit the use of overdrafts by customers as a form of short-term, high-cost credit, including, for example, giving customers who overdraw their accounts on more than six occasions where a fee is charged in a rolling 12 month period a reasonable opportunity to choose a less costly alternative and decide whether to continue with fee-based overdraft coverage. It also encourages placing appropriate daily limits on overdraft fees, and asks banks to consider eliminating overdraft fees for transactions that overdraw an account by a *de minimis* amount. Overdraft policies, processes, fees and disclosures are frequently the subject of litigation against banks in various jurisdictions.

The Dodd-Frank Act established the CFPB, which began exercising its regulatory authority upon the recess appointment of its director on January 4, 2012. The CFPB has the authority, previously exercised by the federal bank regulators to adopt regulations and enforce various laws, including the ECOA, and other fair lending laws, the Truth in Lending Act, the Electronic Funds Transfer Act, mortgage lending rules, Truth in Savings, Fair Credit Reporting and Privacy of Consumer Financial Privacy. Although the CFPB does not examine or supervise banks with less than \$10 billion in assets, it exercises broad authority that affects bank regulation in these areas and bank regulators consumer examination and enforcement. Banks of all sizes will be subject to changes as the CFPB reviews and revises the regulations it administers, and its enforcement actions. The CFPB has focused on various practices to date, including revising mortgage lending rules, credit card add-on products, indirect automobile lending, student lending, and payday and similar short-term lending, and has a broad mandate to regulate consumer financial products, whether or not offered by banks or their affiliates.

### *Residential Mortgages*

The CFPB's final regulations implementing the Dodd-Frank Act requirement that lenders determine whether a consumer has the ability to repay a mortgage loan became effective January 10, 2014. These establish certain minimum requirements for creditors when making ability to pay determinations, and provide certain safe harbors from liability for mortgages that are qualified mortgages and are not higher-priced. Generally, these CFPB regulations apply to all consumer, closed-end loans secured by a dwelling including home-purchase loans, refinances and home equity loans whether first or subordinate lien. Qualified mortgages must generally satisfy detailed requirements related to product features, underwriting standards, and requirements where the total points and fees on a mortgage loan cannot exceed specified amounts or percentages of the total loan amount. Qualified mortgages must have: (1) a term not exceeding 30 years; (2) regular periodic payments that do not result in negative amortization, deferral of principal repayment, or a balloon payment; (3) and be supported with documentation of the borrower and its credit. We anticipate focusing our residential mortgage origination on qualified mortgages and those that meet our investors requirements, but we may make loans that do not meet the safe harbor requirements for qualified mortgages. Our residential mortgage strategy, product offerings, and profitability may change as these regulations are interpreted and applied in practice.

The bank generally services the loans it originates, including those it sells. The CFPB adopted new mortgage servicing standards, effective in January 2014. These include new requirements regarding force-placed insurance, certain notices prior to rate adjustments on adjustable rate mortgages, and periodic disclosures to borrowers. Servicers will be prohibited from processing foreclosures when a loan modification is pending, and must wait until a loan is more than



120 days delinquent before initiating a foreclosure action. Servicers must provide direct and ongoing access to its personnel, and provide prompt review of any loss mitigation application. Servicers must maintain accurate and accessible mortgage records for the life of a loan and until one year after the loan is paid off or transferred. These new standards are expected to increase the cost and compliance risks of servicing mortgage loans, and the mandatory delays in foreclosures could result in loss of value on collateral or the proceeds we may realize from a sale of foreclosed property.

The CFPB's new Truth in Lending Act - Real Estate Settlement Procedures Act ( RESPA ) rule and the related integrated disclosures (sometimes called TRID ), became effective October 3, 2015 for closed-end and credit transactions secured by real property.

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The Federal Housing Finance Authority ( FHFA ) updated Fannie Mae s and Freddie Mac s (individually and collectively, GSE ) repurchase rules, including the kinds of loan defects that could lead to a repurchase request to, or alternative remedies with, the mortgage loan originator or seller. These rules became effective January 1, 2016. FHFA also has updated these GSEs representations and warranties framework and announced on February 2, 2016 an independent dispute resolution ( IDR ) process to allow a neutral third party to resolve demands after the GSE s quality control and appeal processes have been exhausted. The GSEs are expected to update their repurchase demand escalation and appeal processes later this year to resolve disputes before any IDR process begins.

Our residential mortgage strategy, product offerings, and profitability may change as these regulations are interpreted and applied in practice, and may also change due to any restructuring of Fannie Mae and Freddie Mac as part of the resolution of their conservatorships.

## **Other Laws and Regulations**

The International Money Laundering Abatement and Anti-Terrorism Funding Act of 2001 specifies new know your customer requirements that obligate financial institutions to take actions to verify the identity of the account holders in connection with opening an account at any U.S. financial institution. Bank regulators are required to consider compliance with this Act s money laundering provisions in acting upon acquisition and merger proposals, and sanctions for violations of this Act can be imposed in an amount equal to twice the sum involved in the violating transaction, up to \$1 million.

Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA PATRIOT Act ), financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as to enhanced due diligence and know your customer standards in their dealings with foreign financial institutions and foreign customers.

The USA PATRIOT Act requires financial institutions to establish anti-money laundering programs, and sets forth minimum standards for these programs, including:

the development of internal policies, procedures, and controls;

the designation of a compliance officer;

an ongoing employee training program; and

an independent audit function to test the programs.

The Company is also required to comply with various corporate governance and financial reporting requirements under the Sarbanes-Oxley Act of 2002, as well as new rules and regulations adopted by the SEC, the Public Company Accounting Oversight Board and Nasdaq. In particular, the Company is required to report on internal controls as part of its annual report for the year ended December 31, 2015 pursuant to Section 404 of the Sarbanes-Oxley Act. The Company has evaluated its controls, including compliance with the SEC rules on internal controls, and has and expects to continue to spend significant amounts of time and money on compliance with these rules. If the Company fails to comply with these internal control rules in the future, it may materially adversely affect its reputation, its

ability to obtain the necessary certifications to its financial statements, its relations with its regulators and other financial institutions with which it deals, and its ability to access the capital markets and offer and sell Company securities on terms and conditions acceptable to the Company. The Company's assessment of its financial reporting controls as of December 31, 2015 are included elsewhere in this report with no material weaknesses reported.

### **Payment of Dividends**

The Company is a legal entity separate and distinct from the Bank. The Company's primary source of cash is dividends from the Bank. Prior regulatory approval is required if the total of all dividends declared by a state member bank (such as the Bank) in any calendar year will exceed the sum of such bank's net profits for the year and its retained net profits for the preceding two calendar years, less any required transfers to surplus. During 2015, the Bank paid cash dividends of approximately \$3.5 million to the Company. At December 31, 2015, the Bank could have declared additional dividends of approximately \$12.3 million without prior approval of regulatory authorities.

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In addition, the Company and the Bank are subject to various general regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. The appropriate federal and state regulatory authorities are authorized to determine when the payment of dividends would be an unsafe or unsound practice, and may prohibit such dividends. The Federal Reserve has indicated that paying dividends that deplete a state member bank's capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve has indicated that depository institutions and their holding companies should generally pay dividends only out of current year's operating earnings.

Under Federal Reserve Supervisory Letter SR-09-4 (February 24, 2009), as revised December 21, 2015, the board of directors of a bank holding company must consider different factors to ensure that its dividend level is prudent relative to maintaining a strong financial position, and is not based on overly optimistic earnings scenarios, such as potential events that could affect its ability to pay, while still maintaining a strong financial position. As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should consult with the Federal Reserve and eliminate, defer or significantly reduce the bank holding company's dividends if:

its net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;

its prospective rate of earnings retention is not consistent with its capital needs and overall current and prospective financial condition; or

It will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

When fully-phased in by 2019, the Basel III capital rules will further limit permissible dividends, stock repurchases and discretionary bonuses by the Company and the Bank, respectively, unless the Company and the Bank meet the full capital conservation buffer requirement. See Basel III Capital Rules.

## **Capital**

The Federal Reserve has risk-based capital guidelines for bank holding companies and state member banks, respectively. These guidelines required at year end 2015 a minimum ratio of capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) of 8%. At least half of the total capital must consist of common equity and related retained earnings. A limited amount of qualifying preferred stock, less goodwill and certain core deposit intangibles are also added as part of Tier 1 Capital ( Tier 1 capital ). Voting common equity must be the predominant form of capital. The remainder may consist of non-qualifying preferred stock, qualifying subordinated, perpetual, and/or mandatory convertible debt, term subordinated debt and intermediate term preferred stock, up to 45% of pretax unrealized holding gains on available for sale equity securities with readily determinable market values that are prudently valued, and a limited amount of general loan loss allowance ( Tier 2 capital and, together with Tier 1 capital, Total risk-based capital ).

In addition, the Federal Reserve has established minimum leverage ratio guidelines for bank holding companies not subject to the Small BHC Policy, and state member banks, which provide for a minimum leverage ratio of Tier 1 capital to adjusted average quarterly assets ( leverage ratio ) equal to 3%, plus an additional cushion of 1.0% to 2.0%, if the institution has less than the highest regulatory rating. The minimum capital ratios sought by the regulators are increasing, and a 5% leverage ratio is the minimum for the largest institutions. The guidelines also provide that

institutions experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. Higher capital may be required in individual cases and depending upon a bank holding company's risk profile. All bank holding companies and banks are expected to hold capital commensurate with the level and nature of their risks including the volume and severity of their problem loans. Lastly, the Federal Reserve's guidelines indicate that the Federal Reserve will continue to consider a tangible Tier 1 leverage ratio (deducting all intangibles) in evaluating proposals for expansion or new activity. The level of Tier 1 capital to risk-adjusted assets is becoming more widely used by the bank regulators to measure capital adequacy. The Federal Reserve has not advised the Company or the Bank of any specific minimum leverage ratio or tangible Tier 1 leverage ratio applicable to them. Under Federal Reserve policies, bank holding companies are generally expected to operate with capital positions well above the minimum ratios. The Federal Reserve believes the risk-based ratios do not take into account the quality of capital and interest rate, liquidity, market and operational risks. Accordingly, supervisory assessments of capital adequacy may differ significantly from conclusions based solely on the level of an organization's risk-based capital ratio.

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The Federal Deposit Insurance Corporation Improvement Act of 1991 ( FDICIA ), among other things, requires the federal banking agencies to take prompt corrective action regarding depository institutions that do not meet minimum capital requirements. FDICIA establishes five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. A depository institution s capital tier will depend upon how its capital levels compare to various relevant capital measures and certain other factors, as established by regulation.

All of the federal bank regulatory agencies have regulations establishing risk-adjusted measures and relevant capital levels implementing the prompt corrective action standards. The relevant capital measures are the total risk-based capital ratio, Tier 1 risk-based capital ratio, Common Equity Tier 1 capital ratio, as well as, the leverage capital ratio. Under the regulations, a state member bank will be: (i) well capitalized if it has a total risk-based capital ratio of 10% or greater, a Tier 1 risk-based capital ratio of 8% or greater, a Common Equity Tier 1 capital ratio of 6.5% or greater, a leverage capital ratio of 5% or greater and is not subject to any written agreement, order, capital directive or prompt corrective action directive by a federal bank regulatory agency to maintain a specific capital level for any capital measure; (ii) adequately capitalized if it has a total risk-based capital ratio of 8% or greater, a Tier 1 risk-based capital ratio of 6% or greater, a Common Equity Tier 1 capital ratio of 4.5% or greater, and generally has a leverage capital ratio of 4% or greater; (iii) undercapitalized if it has a total risk-based capital ratio of less than 8%, a Tier 1 risk-based capital ratio of less than 6%, a Common Equity Tier 1 capital ratio of less than 4.5% or generally has a leverage capital ratio of less than 2%; (iv) significantly undercapitalized if it has a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 4%, a Common Equity Tier 1 capital ratio of less than 3%, or a leverage capital ratio of less than 3%; or (v) critically undercapitalized if its tangible equity is equal to or less than 2% to total assets. The federal bank regulatory agencies have authority to require additional capital, and have been indicating that higher capital levels may be required in light of current market conditions and risk.

The Dodd Frank Act significantly modified the capital rules applicable to the Company and calls for increased capital, generally.

The generally applicable prompt corrective action leverage and risk-based capital standards (the generally applicable standards ), including the types of instruments that may be counted as Tier 1 capital, will be applicable on a consolidated basis to depository institution holding companies (except for such companies subject to the Small BHC Policy), as well as their bank and thrift subsidiaries.

The generally applicable standards in effect prior to the Dodd-Frank Act will be floors for the standards to be set by the regulators.

Bank and thrift holding companies with assets of less than \$15 billion as of December 31, 2009, will be permitted to include trust preferred securities that were issued before May 19, 2010, as Tier 1 capital, but trust preferred securities issued by a bank holding company (other than those with assets of less than \$1 billion that meet the Federal Reserve s qualitative standards under the Small BHC Policy) after May 19, 2010, will no longer count as Tier 1 capital.

The Dodd-Frank Act also requires studies of the use of hybrid instruments as capital, and of smaller (consolidated assets of \$5 billion or less) financial companies access to the capital markets.

Information concerning the Company's and the Bank's regulatory capital ratios at December 31, 2015 is included in Note 19 of the consolidated financial statements that accompany this report.

Depository institutions that are no longer well capitalized for bank regulatory purposes must receive a waiver from the FDIC prior to accepting or renewing brokered deposits. FDICIA generally prohibits a depository institution from making any capital distribution (including paying dividends) or paying any management fee to its holding company, if the depository institution thereafter would be undercapitalized. Institutions that are undercapitalized are subject to growth limitations and are required to submit a capital restoration plan for approval. A depository institution's parent holding company must guarantee that the institution will comply with such capital restoration plan. The aggregate liability of the parent holding company is limited to the lesser of 5% of the depository institution's total assets at the time it became undercapitalized and the amount necessary to bring the institution into compliance with applicable capital standards. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized. If the controlling holding company fails to fulfill its obligations under FDICIA and files (or has filed against it) a petition under the federal Bankruptcy Code, the claim against the holding company's capital restoration obligation would be entitled to a priority in such bankruptcy proceeding over third party creditors of the bank holding company. Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver.

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or conservator. Because the Company and the Bank exceed applicable capital requirements, the respective managements of the Company and the Bank do not believe that the provisions of FDICIA have had or will have any material impact on the Company and the Bank or their respective operations.

### **Basel III Capital Rules**

The Federal Reserve and the other bank regulators adopted in June 2013 final capital rules for bank holding companies and banks implementing the Basel Committee on Banking Supervision's Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems. These new U.S. capital rules are called the Basel III Rules.

The Basel III Rules limits Tier 1 capital to common stock and noncumulative perpetual preferred stock, as well as trust preferred securities and cumulative perpetual preferred stock issued before May 19, 2010, each of which are permanently grandfathered in Tier 1 capital for bank holding companies with less than \$15 billion in assets. A new capital measure, Common Equity Tier I Capital or CET1, is introduced. CET1 includes common stock and related surplus, retained earnings and, subject to certain adjustments, minority common equity interests in subsidiaries. CET1 is reduced by deductions for:

Goodwill and other intangibles, other than mortgage servicing assets ( MSAs ), which are treated separately, net of associated deferred tax liabilities ( DTLs );

Deferred tax assets ( DTAs ) arising from operating losses and tax credit carryforwards net of allowances and DTLs;

Gains on sale from any securitization exposure; and

Defined benefit pension fund net assets (i.e., excess plan assets), net of associated DTLs.

The Company made a one-time election in its first regulatory report in 2015 and, as a result, CET1 would not be further adjusted for certain accumulated other comprehensive income ( AOCI ).

Additional threshold deductions of the following that are individually greater than 10% of CET1 or collectively greater than 15% of CET1 (after above deductions are also made):

MSAs, net of associated DTLs;

DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of any valuation allowances and DTLs; and

Significant common stock investments in unconsolidated financial institutions, net of associated DTLs.



Noncumulative perpetual preferred stock, Tier 1 minority interest not included in CET1, subject to limits, and current Tier 1 capital instruments issued to the U.S. Treasury, including shares issued pursuant to the TARP or SBLF programs, will qualify as additional Tier I capital. All other qualifying preferred stock, subordinated debt and qualifying minority interests will be included in Tier 2 capital.

In addition to the minimum risk-based capital requirements, a new capital conservation buffer of CET1 capital of at least 2.5% of total risk weighted assets, will be required. The capital conservation buffer will be calculated as the *lowest* of:

the banking organization's CET1 capital ratio minus 4.5%;

the banking organization's tier 1 risk-based capital ratio minus 6.0%; and

the banking organization's total risk-based capital ratio minus 8.0%.

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When fully-phased in by 2019, permissible dividends, stock repurchases and discretionary bonuses will be limited to the following percentages based on the capital conservation buffer as calculated above, subject to any further regulatory limitations, including those based on risk assessments and enforcement actions:

<b>Buffer %</b>	<b>Buffer % Limit</b>
More than 2.50%	None
> 1.875% - 2.50%	60.0%
> 1.250% - 1.875%	40.0
> 0.625% - 1.250%	20.0
£ 0.625	- 0 -

The various capital elements and total capital under the Basel III Rules, when fully phased by January 1, 2019 will be:

	<b>December 31, 2015</b>	<b>Fully Phased In January 1, 2019</b>
Minimum CET1	4.50%	4.5%
CET1 Conservation Buffer		2.5%
Total CET1	4.50%	7.0%
Deductions and threshold deductions	40%	100%
Minimum Tier 1 Capital	6.0%	6.0%
Minimum Tier 1 Capital <i>plus</i> conservation buffer	6.0%	8.5%
Minimum Total Capital	8.0%	8.0%
Minimum Total Capital <i>plus</i> conservation buffer	8.0%	10.5%
<i>Changes in Risk-Weightings</i>		

Basel III significantly changes the risk weightings used to determine risk weighted capital adequacy. Among various other changes, Basel III applies a 250% risk-weighting to mortgage servicing rights, deferred tax assets that cannot be realized through net operating loss carry-backs and significant (greater than 10%) investments in other financial institutions. The proposal also would change the risk-weighting for residential mortgages, including mortgages sold. A new 150% risk-weighted category would apply to high volatility commercial real estate loans, which are credit facilities for the acquisition, construction or development of real property other than one-to-four family residential properties or commercial real projects where: (i) the loan-to-value ratio is not in excess of interagency real estate lending standards; and (ii) the borrower has contributed capital equal to not less than 15% of the real estate's as completed value before the loan was made.

The Basel III Rules also change some of the risk weightings used to determine risk-weighted capital adequacy. Among other things, the Basel III Rules:

Assign a 250% risk weight to MSAs;

Assign up to a 1,250% risk weight to structured securities, including private label mortgage securities, trust preferred CDOs and asset backed securities;

Retain existing risk weights for residential mortgages, but assign a 100% risk weight to most commercial real estate loans and a 150% risk-weight for high volatility commercial real estate loans;

Assign a 150% risk weight to past due exposures (other than sovereign exposures and residential mortgages);

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Assign a 250% risk weight to DTAs, to the extent not deducted from capital (subject to certain maximums);

Retain the existing 100% risk weight for corporate and retail loans; and

Increase the risk weight for exposures to qualifying securities firms from 20% to 100%.

*Changes to Prompt Corrective Action Rules*

Under the Basel III Rules, the prompt corrective action rules and categories changed as of January 1, 2015. The following illustrates the range of the changes from well capitalized, to undercapitalized to critically undercapitalized categories. The adequately capitalized and significantly undercapitalized categories also would be retained with appropriate changes, but are not included in the following illustration.

	<u>Pre-2015</u>	<u>Minimums</u>	<u>Basel III</u>
<b>Well capitalized</b>			
CET1			6.5%
Tier 1 risk-based capital	6.0%		8.0%
Total risk-based capital	10.0%		10.0%
Tier 1 leverage ratio	5.0%		5.0%
<b>Undercapitalized</b>			
CET1			< 4.5%
Tier 1 risk-based capital	< 4.0%		£ 6.0%
Total risk-based capital	< 8.0%		< 8.0%
Tier 1 leverage ratio	< 5.0%		< 4.0%
<b>Critically undercapitalized</b>			
	Tangible equity to total	Tier 1 capital plus non-Tier 1	
	assets £ 2.0%	perpetual preferred stock to	
		total assets £ 2.0%	

**FDICIA**

FDICIA directs that each federal bank regulatory agency prescribe standards for depository institutions and depository institution holding companies relating to internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth composition, a maximum ratio of classified assets to capital, minimum earnings sufficient to absorb losses, a minimum ratio of market value to book value for publicly traded shares, safety and soundness, and such other standards as the federal bank regulatory agencies deem appropriate.

**Enforcement Policies and Actions**

The Federal Reserve and the Alabama Superintendent monitor compliance with laws and regulations. Violations of laws and regulations, or other unsafe and unsound practices, may result in these agencies imposing fines or penalties, cease and desist orders, or taking other formal or informal enforcement actions. Under certain circumstances, these agencies may enforce these remedies directly against officers, directors, employees and others participating in the affairs of a bank or bank holding company.

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### **Fiscal and Monetary Policy**

Banking is a business that depends on interest rate differentials. In general, the difference between the interest paid by a bank on its deposits and its other borrowings, and the interest received by a bank on its loans and securities holdings, constitutes the major portion of a bank's earnings. Thus, the earnings and growth of the Company and the Bank, as well as the values of, and earnings on, its assets and the costs of its deposits and other liabilities are subject to the influence of economic conditions generally, both domestic and foreign, and also to the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve. The Federal Reserve regulates the supply of money through various means, including open market dealings in United States government securities, the discount rate at which banks may borrow from the Federal Reserve, and the reserve requirements on deposits.

The Federal Reserve lowered its target federal funds rate from 5.25% per annum on August 7, 2007 to 3.00% on January 30, 2008, and finally to 0-0.25% on December 16, 2008, where it remained until December 16, 2015 when it was raised to 0.50%. On December 16, 2015, the Federal Reserve increased the discount rate to 1.00%. The Federal Reserve's discount rate on bank borrowings from the Federal Reserve, at 5.57% per annum on September 17, 2007, was steadily lowered to 4.75% on January 2, 2008, to 1.25% on October 28, 2008, and to 0.50% on December 16, 2008, where it remained until an increase on February 19, 2010 to 0.75%.

On April 30, 2010, the Federal Reserve Board amended Regulation D (Reserve Requirements of Depository Institutions) authorizing the Reserve Banks to offer term deposits to certain institutions. Term deposits, which are deposits with specified maturity dates, will be offered through a Term Deposit Facility (TDF). Term deposits will be one of several tools that the Federal Reserve could employ to drain reserves when policymakers judge that it is appropriate to begin moving to a less accommodative stance of monetary policy.

Beginning October 6, 2008, the Federal Reserve has been paying interest on depository institutions' required and excess reserve balances. The payment of interest on excess reserve balances was expected to give the Federal Reserve greater scope to use its lending programs to address conditions in credit markets while also maintaining the federal funds rate close to the target rate established by the Federal Open Market Committee. The Federal Reserve has indicated that it may use this authority to implement a mandatory policy to reduce excess liquidity, in the event of inflation or the threat of inflation.

In 2011, the Federal Reserve repealed its historical Regulation Q to permit banks to pay interest on demand deposits. The Federal Reserve has also engaged in several rounds of quantitative easing (QE) to reduce interest rates by buying bonds, and Operation Twist to reduce long term interest rates by buying long term bonds, while selling intermediate term securities. In October 2014, the Federal Reserve ended its bond purchases under QE after it began to taper the level of bonds purchased in December 2013, but has continued to reinvest the principal of its existing securities as these mature.

The nature and timing of any changes in such policies and their effect on the Company and the Bank cannot be predicted.

### **FDIC Insurance Assessments**

The Bank's deposits are insured by the FDIC's DIF, and the Bank is subject to FDIC assessments for its deposit insurance, as well as assessments by the FDIC to pay interest on Financing Corporation (FICO) bonds.

Effective April 1, 2011, and as discussed above under Recent Regulatory Developments, the FDIC began calculating assessments based on an institution's average consolidated total assets less its average tangible equity (the FDIC

Assessment Base ) in accordance with changes mandated by the Dodd-Frank Act. The FDIC changed its assessment rates which shifted part of the burden of deposit insurance premiums toward depository institutions relying on funding sources other than U.S. deposits. Initial base assessment rates applicable to second quarter 2011 assessments (and prospectively until the DIF reserve ratio reaches 1.15 percent) are as follows:

<b>Risk Category</b>	<b>Deposit Insurance Assessment Rate</b>
I	5 to 9 basis points
II	14 basis points
III	23 basis points
IV	35 basis points

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An institution's overall rate may be higher by as much as 10 basis points or lower by as much as 2-5 basis points depending on adjustments to the base rate for unsecured debt and/or brokered deposits. Furthermore, under the new system, different rate schedules will take effect when the DIF reserve ratio reaches certain levels. For example, for banks in risk category II, the initial base assessment rate will be 14 basis points when the DIF reserve ratio is below 1.15 percent, 12 basis points when the DIF reserve ratio is between 1.15 percent and 2 percent, 10 basis points when the DIF reserve ratio is between 2 percent and 2.5 percent and 9 basis points when the DIF reserve ratio is 2.5 percent or higher.

Since inception of the new schedule, the Bank's overall rate for assessment calculations has been 9 basis points or less, which is within the range of assessment rates for Risk Category I. In both 2015 and 2014, the Company recorded \$0.4 million in expense for FDIC insurance premiums.

In addition, all FDIC-insured institutions are required to pay a pro rata portion of the interest due on FICO bonds, which mature during 2017 through 2019. FICO assessments are set by the FDIC quarterly on each institution's FDIC Assessment Base. The FICO assessment was 0.62 basis points in all four quarters of 2014 and 0.60 basis points in all of 2015, except for the third quarter of 2015. The FICO assessment was 0.58 basis points in the third quarter of 2015. The FICO assessment rate for the first quarter of 2016 was 0.58 basis points. FICO assessments of approximately \$43 thousand and \$42 thousand were paid to the FDIC in 2014 and 2015, respectively.

On October 22, 2015, the FDIC Board of Directors approved a Notice of Proposed Rulemaking ( NPR ) to implement Dodd-Frank provisions (1) raising the DIF's minimum reserve ratio from 1.15 % to 1.35 %; (2) requiring that the DIF reserve ratio reach 1.35 % by September 30, 2020; and (3) requiring that the FDIC offset the effect of the increase in the minimum reserve ratio on insured depository institutions with total consolidated assets of less than \$10 billion ( Small Banks ). The NPR proposes to surcharge insured depository institutions with total consolidated assets of \$10 billion or more and grant credits to banks with fewer assets for the portion of their regular assessments that contribute to increasing the reserve ratio from 1.15 % to 1.35 %. Since this proposal is not final, its effects on us cannot be predicted. However, if adopted, it is likely to shift potential additional FDIC DIF costs away from Small Banks like us, to larger depository institutions.

## **Lending Practices**

The federal bank regulatory agencies released guidance in 2006 on Concentrations in Commercial Real Estate Lending (the Guidance ). The Guidance defines commercial real estate ( CRE ) loans as exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50% or more of the source of repayment comes from third party, non-affiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of this property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risks in CRE markets would also be considered CRE loans under the Guidance. Loans on owner occupied CRE are generally excluded.

The Guidance requires that appropriate processes be in place to identify, monitor and control risks associated with real estate lending concentrations. This could include enhanced strategic planning, CRE underwriting policies, risk management, internal controls, portfolio stress testing and risk exposure limits as well as appropriately designed compensation and incentive programs. Higher allowances for loan losses and capital levels may also be required. The Guidance is triggered when either: This Guidance was supplemented by the Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending (December 18, 2015).



Total reported loans for construction, land development, and other land of 100% or more of a bank's total capital; or

Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land are 300% or more of a bank's total risk-based capital. The Guidance also applies when a bank has a sharp increase in CRE loans or has significant concentrations of CRE secured by a particular property type.

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The Guidance did not apply to the Bank's CRE lending activities at year-end 2015. At December 31, 2015, the Bank had outstanding \$44.0 million in construction and land development loans and \$200.1 million in total CRE loans (excluding owner occupied), which represent approximately 50.4% and 229.3%, respectively, of the Bank's total risk-based capital at December 31, 2015. The Company has always had significant exposures to loans secured by commercial real estate due to the nature of its markets and the loan needs of both its retail and commercial customers. The Company believes its long term experience in CRE lending, underwriting policies, internal controls, and other policies currently in place, as well as its loan and credit monitoring and administration procedures, are generally appropriate to manage its concentrations as required under the Guidance. The federal bank regulators continue to look at the risks of various assets and asset categories and risk management.

The Bank did not have any loans at year-end 2015 that were leveraged loans subject to the Interagency Guidance on Leveraged Lending (February 19, 2013).

## **Other Dodd-Frank Act Provisions**

The Dodd-Frank Act was signed into law on July 21, 2011. In addition to the capital, liquidity and FDIC deposit insurance changes discussed above, some of the provisions of the Dodd-Frank Act we believe may affect us are set forth below.

### *Financial Stability Oversight Council*

The Dodd-Frank Act creates the Financial Stability Oversight Council or FSOC, which is chaired by the Secretary of the Treasury and composed of representatives from various financial services regulators. The FSOC has responsibility for identifying risks and responding to emerging threats to financial stability.

### *Executive Compensation*

The Dodd-Frank Act provides for a say on pay for shareholders of all public companies. Under the Dodd-Frank Act, each company must give its shareholders the opportunity to vote on the compensation of its executives, on a non-binding advisory basis, at least once every three years. The Dodd-Frank Act also adds disclosure and voting requirements for golden parachute compensation that is payable to named executive officers in connection with sale transactions.

The SEC is required under the Dodd-Frank Act to issue rules obligating companies to disclose in proxy materials for annual shareholders meetings, information that shows the relationship between executive compensation actually paid to their named executive officers and their financial performance, taking into account any change in the value of the shares of a company's stock and dividends or distributions. The Dodd-Frank Act also provides that a company's compensation committee may only select a compensation consultant, legal counsel or other advisor after taking into consideration factors to be identified by the SEC that affect the independence of a compensation consultant, legal counsel or other advisor.

Section 954 of the Dodd-Frank Act added section 10D to the Exchange Act. Section 10D directs the SEC to adopt rules prohibiting a national securities exchange or association from listing a company unless it develops, implements, and discloses a policy regarding the recovery or claw-back of executive compensation in certain circumstances. The policy must require that, in the event an accounting restatement due to material noncompliance with a financial reporting requirement under the federal securities laws, the company will recover from any current or former executive officer any incentive-based compensation (including stock options) received during the three year period preceding the date of the restatement, which is in excess of what would have been paid based on the restated financial

statements. There is no requirement of wrongdoing by the executive, and the claw-back is mandatory and applies to all executive officers. Section 954 augments section 304 of the Sarbanes-Oxley Act of 2002 ( SOX ), which requires the CEO and CFO to return any bonus or other incentive or equity-based compensation received during the 12 months following the date of similarly inaccurate financial statements, as well as any profit received from the sale of employer securities during the period, if the restatement was due to misconduct. Unlike section 304, under which only the SEC may seek recoupment, the Dodd-Frank Act requires the company to seek the return of compensation.

The SEC issued proposed Rule 10D-1 under Section 954 on July 1, 2015 that would direct Nasdaq and the other national securities exchanges to adopt listing standards requiring companies to adopt policies requiring executive officers to pay back erroneously awarded incentive-based compensation.

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The Dodd-Frank Act requires the SEC, by rule, to require that each company disclose in the proxy materials for its annual meetings whether an employee or board member is permitted to purchase financial instruments designed to hedge or offset decreases in the market value of equity securities granted as compensation or otherwise held by the employee or board member.

Section 956 of the Dodd-Frank Act prohibits incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions and are deemed to be excessive, or that may lead to material losses. On June 21, 2010, the federal bank regulators adopted *Guidance on Sound Incentive Compensation Policies*, which, although targeted to larger, more complex organizations than the Company, includes principles that have been applied to smaller organizations similar to the Company. This Guidance applies to incentive compensation to executives as well as employees, who, individually or a part of a group, have the ability to expose the relevant banking organization to material amounts of risk. Incentive compensation should:

- Provide employees incentives that appropriately balance risk and reward;
- Be compatible with effective controls and risk-management;
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

The federal bank regulators, the SEC and other regulators proposed regulations implementing Section 956 in April 2011, but no regulations have been adopted.

### *Other*

The Dodd-Frank Act requires an estimated 240-300 rulemakings and an estimated 130 studies. Many of the rules have not yet been proposed or adopted, and many are complex and require consultation among a variety of agencies, and their effects upon us, whether directly, or indirectly on the regulation and cost imposed on the markets and on others with whom we do business cannot be predicted. Many of the rules lack authoritative interpretative guidance from the applicable government agencies.

### *Corporate Governance*

The Dodd-Frank Act clarifies that the SEC may, but is not required to promulgate rules that would require that a company's proxy materials include a nominee for the board of directors submitted by a shareholder.

The Dodd-Frank Act requires stock exchanges to have rules prohibiting their members from voting securities that they do not beneficially own (unless they have received voting instructions from the beneficial owner) with respect to the election of a member of the board of directors, executive compensation or any other significant matter, as determined by the SEC by rule.

### *Credit Ratings*

The Dodd-Frank Act includes a number of provisions that are targeted at improving the reliability of credit ratings. The federal bank regulators and the SEC have adopted rules to implement the Act's requirement to delete references to rating agency ratings for various purposes, including investment securities, which are permissible bank investments.

### *Debit Card Interchange Fees*

The Durbin Amendment to the Dodd-Frank Act provides for a set of new rules requiring that interchange transaction fees for electric debit transactions be reasonable and proportional to certain costs associated with processing the transactions. The Federal Reserve has established standards for assessing whether interchange fees are reasonable and proportional, which a Federal District Court ruled were improperly adopted. This decision in *NACS v. Board of Governors of the Federal Reserve System*, was reversed by the District of Columbia Circuit Court of Appeals in 2014 and the Supreme Court declined to hear an appeal on January 20, 2015.

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*Derivatives*

The Dodd-Frank Act requires a new regulatory system for the U.S. market for swaps and other over-the-counter derivatives, which includes strict capital and margin requirements, central clearing of standardized over-the-counter derivatives, and heightened supervision of over-the-counter derivatives dealers and major market participants. These rules could increase the costs and collateral required to utilize derivatives that we could find useful to reduce our interest rate and other risks.

**Other Legislative and Regulatory Changes**

Various legislative and regulatory proposals, in addition to those mandated by the Dodd-Frank Act, regarding substantial changes in banking, and the regulation of banks, thrifts and other financial institutions, compensation, and the regulation of financial markets and their participants and financial instruments, and the regulators of all of these, as well as the taxation of these entities, are being considered by the executive branch of the federal government, Congress and various state governments, including Alabama. Certain of these proposals, if adopted, could significantly change the regulation or operations of banks and the financial services industry. New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation's financial institutions.

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**ITEM 1A. RISK FACTORS**

Any of the following risks could harm our business, results of operations and financial condition and an investment in our stock. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements.

*Difficult market conditions have adversely affected our industry.*

We are exposed to downturns in the U.S. economy, although the local markets in which we operate in East Alabama were not as adversely affected during 2007-2010 as various other areas of the country. Although declines in the housing market appear to be improving, declines in home prices and high levels of foreclosures, unemployment and under-employment since 2007, have negatively affected the credit performance of mortgage loans and resulted in significant write-downs of asset values by various financial institutions, including government-sponsored entities as well as major commercial and investment banks. This market turmoil and the tightening of available credit led to increased levels of commercial and consumer delinquencies, reduced consumer confidence, increased market volatility and reductions in business activity, although signs of stabilization and some recovery have continued to evolve. Failures increased among financial services companies, and various companies, weakened by market conditions, have merged with other institutions.

We believe the following, among other things, may affect us in 2016:

We expect to face continued high levels of regulation of our industry as a result of continued Dodd-Frank Act rulemaking and other initiatives by the U.S. government and its regulatory agencies, including the CFPB. Compliance with such regulations may increase our costs, reduce our profitability, and limit our ability to pursue business opportunities and serve customers' needs. Although there has been discussion of regulatory relief for banking organizations of our size, we do not expect material regulatory relief in 2016.

Although employment is increasing, the economy is growing relatively slowly, and the Federal Reserve has indicated concerns over raising interest rates to more normal levels in light of domestic and global uncertainty.

Market developments, including employment and price levels, may affect consumer confidence levels from time to time in different directions, and may cause adverse changes in payment behaviors and payment rates, causing increases in delinquencies and default rates, which could affect our charge-offs and provisions for credit losses.

Our ability to assess the creditworthiness of our customers and those we do business with, and to estimate the values of our assets and collateral for loans may be impaired if the models and approaches we use become less predictive of future behaviors, valuations, assumptions or estimates. The process we use to estimate losses inherent in our credit exposure or estimate the value of certain assets requires difficult, subjective, and complex judgments, including forecasts of economic conditions and how these economic predictions might affect the ability of our borrowers to repay their loans or the value of assets.

Our ability to borrow from and engage in other business with other financial institutions on favorable terms or at all could be adversely affected by disruptions in the capital markets or other events, including, among other things, investor expectations and changes in regulations.

Failures of other depository institutions in our markets and increasing consolidation of financial services companies as a result of market conditions could increase our deposits and assets and necessitate additional capital, and could have unexpected adverse effects upon us and our business.

The Volcker Rule, including final regulations adopted on December 10, 2013, may affect us adversely by reducing securities inventories at those institutions where we buy and sell securities for our portfolio and increasing the bid-ask spreads on securities we purchase or sell. These rules may decrease the range of permissible investments, such as collateral loan obligations ( CLOs ), which we could use to diversify our assets and for asset/liability management.



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*The soundness of other financial institutions could adversely affect us.*

Our ability to engage in routine investment and banking transactions, as well as the quality and values of our investments in equity securities and obligations of other financial institutions, could be adversely affected by the actions, financial condition, and profitability of such other financial institutions with which we deal, including, without limitation, the FHLB and our correspondent banks. At December 31, 2015, the amortized cost of the Bank's investments in FHLB and our correspondent bank's common stock was approximately \$1.1 million. Financial services institutions are interrelated as a result of shared credits, trading, clearing, counterparty and other relationships. As a result, defaults by, or even rumors or questions about, one or more financial institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor or counterparty confidence in certain institutions and could lead to losses or defaults by other institutions, and in some cases, failure of such institutions. Any losses, defaults by, or failures of, the institutions we do business with could adversely affect our holdings of the debt of and equity in, such other institutions, our participation interests in loans originated by other institutions, and our business, including our liquidity, financial condition and earnings.

*Nonperforming and similar assets take significant time to resolve and may adversely affect our results of operations and financial condition.*

At December 31, 2015, our nonaccrual loans totaled \$2.7 million, or 0.64% of total loans. In addition, we had approximately \$0.3 million of other real estate owned at December 31, 2015. Our non-performing assets may adversely affect our net income in various ways. We do not record interest income on nonaccrual loans or OREO and these assets require higher loan administration and other costs, thereby adversely affecting our income. Decreases in the value of these assets, or the underlying collateral, or in the related borrowers' performance or financial condition, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires commitments of time from management, which can be detrimental to the performance of their other responsibilities. There can be no assurance that we will not experience increases in nonperforming loans in the future.

*Our allowance for loan losses may prove inadequate or we may be negatively affected by credit risk exposures.*

Our business depends on the creditworthiness of our customers. We periodically review our allowance for loan losses for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. We cannot be certain that our allowance for loan losses will be adequate over time to cover credit losses in our portfolio because of unanticipated adverse changes in the economy, market conditions or events adversely affecting specific customers, industries or markets, and changes in borrower behaviors. If the credit quality of our customer base materially decreases, if the risk profile of a market, industry or group of customers changes materially or weaknesses in the real estate markets worsen, borrower payment behaviors change, or if our allowance for loan losses is not adequate, our business, financial condition, including our liquidity and capital, and results of operations could be materially adversely affected. The Financial Accounting Standards Board (the FASB) has proposed changing the loss model to take into account current expected losses, or CECL. The final terms and effective date of this proposal are unknown, but could affect our results of operations and financial condition.

*Weaknesses in the real estate markets, including the secondary market for residential mortgage loans, may continue to adversely affect us.*

The effects of the CFPB changes to mortgage and servicing rules effective at the beginning of 2014, the CFPB's new unified Truth-in-Lending Act and Real Estate Settlement Procedures Act (RESPA) rules (TRID) for closed end credit

transactions secured by real property that became effective in October 2015, enforcement actions, reviews and settlements, changes in the securitization rules under the Dodd-Frank Act, and the Basel III Rules, combined with the continuing conservatorships of Fannie Mae and Freddie Mac, the levels of risky assets at the FHA and its relatively low capital and reserves for losses, current levels of home sales, and the risks of interest rates increasing from historically low levels, could have serious adverse effects on the mortgage markets and our mortgage operations. Such effects could include, among other things, price reductions in single family home values, further adversely affecting the liquidity and value of collateral securing commercial loans for residential acquisition, construction and development, as well as residential mortgage loans that we hold, mortgage loan originations and gains on sale of mortgage loans.

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Significant ongoing disruptions in the secondary market for residential mortgage loans have limited the market for and liquidity of most mortgage loans other than conforming Fannie Mae, Freddie Mac, and FHA loans. Declines in real estate values, low home sales volumes, financial stress on borrowers as a result of job losses or reduced incomes, interest rate increases, generally, including resets on adjustable rate mortgage loans, maturities of second lien mortgages or other factors have adversely affected borrowers during recent years. Higher interest rate and changes in mortgage loan rules, could result in fewer mortgage originations, higher delinquencies and greater charge-offs in future periods, as well as increased regulation capital requirement which would adversely affect our financial condition, including capital and liquidity, and our results of operations. In the event our allowance for loan losses is insufficient to cover such losses, if any, our earnings, capital and liquidity could be adversely affected. Fannie Mae and Freddie Mac, the largest purchasers of residential mortgage loans, remain in federal conservatorship and the timing and effects of their resolution cannot be predicted.

Weaknesses in real estate markets may adversely affect the length of time and costs required to manage and dispose of, and the values realized from the sale of our OREO.

*CFPB residential mortgage origination rules may change our business and costs.*

The CFPB's final regulations implementing the Dodd-Frank Act requirement that lenders determine whether a consumer has the ability to repay a mortgage loan became effective in January 2014. These encourage the origination of residential mortgages that meet the new requirements for qualified mortgages. These may adversely affect our product offerings, reduce our mortgage origination volume and increase our costs to originate residential mortgage loans, which could adversely affect our results of operation and financial condition, especially where residential mortgage origination volume is declining, generally.

*We may be contractually obligated to repurchase mortgage loans we sold to third parties on terms unfavorable to us.*

As a routine part of its business, the Company originates mortgage loans that it subsequently sells in the secondary market, including to governmental agencies and government sponsored entities ( GSEs ), such as Fannie Mae. In connection with the sale of these loans, the Company makes customary representations and warranties, the breach of which may result in the Company being required to repurchase the loan or loans. Furthermore, the amount paid may be greater than the fair value of the loan or loans at the time of the repurchase. Although mortgage loan repurchase requests made to us have been limited, if these increased notwithstanding new repurchase procedures adopted in late 2015 and early 2016 by the Federal Housing Finance Agency ( FHFA ), Fannie Mae and Freddie Mac, we may have to establish reserves for possible repurchases and adversely affect our results of operation and financial condition.

*Servicing requirements may change and require us to incur additional costs and risks.*

On February 9, 2012, the DOJ and various state attorneys general announced a \$25 billion agreement with the nation's five largest mortgage servicers to address mortgage loan servicing and foreclosure abuses. While we were not a party to the settlement or a subject of the joint governmental investigation, we cannot be assured that the settlement may ultimately affect mortgage servicing standards generally, which could increase compliance and other costs of servicing residential mortgage loans. The CFPB continues to bring enforcement actions and develop proposals and rules that could increase the costs of providing mortgage servicing. This could reduce our income from servicing these types of loans and make it more difficult and costly to timely realize the value of collateral securing such loans upon a borrower default.

*Changes in residential servicing regulations may have adverse effects on our resales and servicing of residential mortgage loans.*

The CFPB adopted new residential mortgage servicing standards in January 2014 that add additional servicing requirements, increase our required servicer activities and delay foreclosures, among other things. These may adversely affect our costs to service residential mortgage loans, and together with the Basel III Rules, may decrease the returns on our MSR.

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*Fannie Mae and Freddie Mac restructuring may adversely affect the mortgage markets and our sales of mortgages we originated*

Fannie Mae and Freddie Mac remain in conservatorship. In March 2014, bi-partisan legislation was introduced in the U.S. Senate to restructure Fannie Mae and Freddie Mac to take them out of conservatorship and substantially change the way they conduct business in the future. Through 2015, and thereafter all of Fannie Mae and Freddie Mac's earnings have been swept into the U.S. Treasury and have not been available to build these GSE's capital. Since these two entities dominate the residential mortgage markets, any changes and any future capital deficiencies could adversely affect our residential mortgage origination and servicing businesses, our results of operation and the returns on capital deployed in these businesses.

*Our concentration of commercial real estate loans could result in further increased loan losses, and adversely affect our business, earnings, and financial condition.*

Commercial real estate, or CRE, is cyclical and poses risks of possible loss due to concentration levels and risks of the assets being financed, which include loans for the acquisition and development of land and residential construction. We had 57.8% of our portfolio in CRE loans, as defined by the Federal Reserve, at year-end 2015 compared to 56.5% at year-end 2014. The banking regulators continue to give CRE lending scrutiny and further addressed their concerns over CRE activity in December 2015, and require banks with higher levels of CRE loans to implement improved underwriting, internal controls, risk management policies and portfolio stress testing, as well as higher levels of allowances for possible losses and capital levels as a result of CRE lending growth and exposures. Lower demand for CRE, and reduced availability of, and higher costs for, CRE lending could adversely affect our CRE loans and sales of our OREO, and therefore our earnings and financial condition, including our capital and liquidity.

*Our ability to realize our deferred tax assets may be reduced in the future if our estimates of future taxable income from our operations and tax planning strategies do not support this amount, and the amount of net operating loss carry-forwards realizable for income tax purposes may be reduced under Section 382 of the Internal Revenue Code by sales of our capital securities.*

We are allowed to carry-back losses for five years for Federal income tax purposes as otherwise permitted generally under the Worker, Homeownership, and Business Assistance Act of 2009 which was signed into law on November 6, 2009. As of December 31, 2015, we had net deferred tax assets of \$0.2 million. These and future deferred tax assets may be further reduced in the future if our estimates of future taxable income from our operations and tax planning strategies do not support the amount of the deferred tax asset. The amount of net operating loss carry-forwards realizable for income tax purposes potentially could be further reduced under Section 382 of the Internal Revenue Code by a significant offering and/or other sales of our capital securities. The Basel III Rules reduce the regulatory capital benefits of deferred tax assets, also.

*Our future success is dependent on our ability to compete effectively in highly competitive markets.*

The East Alabama banking markets in which we do business are highly competitive and our future growth and success will depend on our ability to compete effectively in these markets. We compete for loans, deposits and other financial services in our markets with other local, regional and national commercial banks, thrifts, credit unions, mortgage lenders, and securities and insurance brokerage firms. Marketplace lenders operating nationwide over the internet are growing rapidly. Many of our competitors offer products and services different from us, and have substantially greater resources, name recognition and market presence than we do, which benefits them in attracting business. In addition, larger competitors may be able to price loans and deposits more aggressively than we are able to and have broader and

more diverse customer and geographic bases to draw upon. The Dodd-Frank Act allows others to branch into our markets more easily from other states. Failures of other banks with offices in our markets could also lead to the entrance of new, stronger competitors in our markets.

*Our success depends on local economic conditions where we operate.*

Our success depends on the general economic conditions in the geographic markets we serve in Alabama. The local economic conditions in our markets have a significant effect on our commercial, real estate and construction loans, the ability of borrowers to repay these loans and the value of the collateral securing these loans. Adverse changes in the economic conditions of the Southeastern United States in general, or in one or more of our local markets could negatively affect our results of operations and our profitability.

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*Our cost of funds may increase as a result of general economic conditions, interest rates, inflation and competitive pressures.*

Although it raised the target federal funds rate by 25 basis points in December 2015, the Federal Reserve to keep interest rates low over recent years, and the federal government continues large deficit spending. Our costs of funds may increase as a result of general economic conditions, interest rates and competitive pressures, and potential inflation resulting from government deficit spending and monetary policies. Traditionally, we have obtained funds principally through local deposits and borrowings from other institutional lenders. Generally, we believe local deposits are a cheaper and more stable source of funds than borrowings because interest rates paid for local deposits are typically lower than interest rates charged for borrowings from other institutional lenders. Increases in interest rates could also change consumers to shift their funds to more interest bearing instruments and to increase the competition for funds. While the Federal Reserve has indicated it will seek to maintain low interest rates, interest rates could increase more than anticipated. See [Fiscal and Monetary Policy](#) .

*Our profitability and liquidity may be affected by changes in interest rates and interest rate levels, the shape of the yield curve and economic conditions.*

Our profitability depends upon net interest income, which is the difference between interest earned on assets, and interest expense on interest-bearing liabilities, such as deposits and borrowings. Net interest income will be adversely affected if market interest rates change where the interest we pay on deposits and borrowings increases faster than the interest earned on loans and investments. Interest rates, and consequently our results of operations, are affected by general economic conditions (domestic and foreign) and fiscal and monetary policies, as well as expectations of these rates and policies and the shape of the yield curve. Decreases in interest rates generally increase the market values of fixed-rate, interest-bearing investments and loans held, and increase the values of loan sales and mortgage loan activities. However, the production of mortgages and other loans and the value of collateral securing our loans, are dependent on demand within the markets we serve, as well as interest rates. The levels of sales, as well as the values of real estate in our markets may remain below the levels of several years ago. Declining interest rates reflect efforts by the Federal Reserve to stimulate the economy, but such efforts may not be effective, and otherwise adversely affect our net interest margin and thus may negatively affect our results of operations and financial condition, liquidity and earnings. The end of new securities purchases under QE and/or increases generally in interest rates by the Federal Reserve, could increase mortgage interest rates and decrease origination volumes.

Increases in interest rates generally decrease the market values of fixed-rate, interest-bearing investments and loans held and the production of mortgage and other loans and the value of collateral securing our loans, and therefore may adversely affect our liquidity and earnings, to the extent not offset by potential increases in our net interest margin.

*The Company is an entity separate and distinct from the Bank.*

The Company is an entity separate and distinct from the Bank. Company transactions with the Bank are limited by Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W. We depend upon the Bank's earnings and dividends, which are limited by law and regulatory policies and actions, for cash to pay the Company's debt and corporate obligations, and to pay dividends to our shareholders. If the Bank's ability to pay dividends to the Company was terminated or limited, the Company's liquidity and financial condition could be materially and adversely affected.

*Liquidity risks could affect operations and jeopardize our financial condition.*

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, proceeds from loan repayments or sales, and other sources could have a substantial negative effect on our liquidity. Our funding sources include federal funds purchased, securities sold under repurchase agreements, core and non-core deposits, and short- and long-term debt. We are also members of the FHLB and the Federal Reserve Bank of Atlanta, where we can obtain advances collateralized with eligible assets. We maintain a portfolio of securities that can be used as a source of liquidity. There are other sources of liquidity available to the Company or the Bank should they be needed, including our ability to acquire additional non-core deposits. We may be able, depending upon market conditions, to otherwise borrow money or issue and sell debt securities including preferred or common securities in public or private transactions. Our access to funding sources in amounts adequate to finance or capitalize our activities or on terms which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Our ability to borrow or obtain funding, if needed, could also be impaired by factors that are not specific to us, such as disruptions in the financial markets or negative views and expectations about the prospects for the financial services industry.



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*We are subject to extensive regulation that could limit or restrict our activities and adversely affect our earnings.*

We and our subsidiaries are regulated by several regulators, including the Federal Reserve, the Alabama Superintendent, the SEC and the FDIC. Our success is affected by state and federal regulations affecting banks and bank holding companies, and the securities markets, and our costs of compliance could adversely affect our earnings. Banking regulations are primarily intended to protect depositors, not shareholders. The financial services industry also is subject to frequent legislative and regulatory changes and proposed changes, and a large number of required Dodd-Frank Act rules have yet to be finalized, and the effects of all these cannot be predicted. Federal bank regulatory agencies and the Treasury, as well as the Congress and the President, are evaluating the regulation of banks, other financial services providers and the financial markets and such changes, if any, could require us to maintain more capital and liquidity, and restrict our activities, which could adversely affect our growth, profitability and financial condition. Our consumer finance products, including residential mortgage loans, are subject to CFPB regulations and evolving standards reflecting CFPB releases, rule-making and enforcement actions.

*Changes in accounting and tax rules applicable to banks could adversely affect our financial conditions and results of operations.*

From time to time, the FASB and the SEC change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in us restating prior period financial statements. FASB has proposed significant changes to the manner in which banks' allowance for loan losses would be calculated. Instead of using historical losses, the proposed CECL model would be forward looking with respect to expected losses over the life of loans. It is unknown when or what form CECL will be adopted. If adopted, it could materially affect our results of operations and financial condition.

*We are required to maintain capital to meet regulatory requirements, and if we fail to maintain sufficient capital, our financial condition, liquidity and results of operations would be adversely affected.*

We and the Bank must meet regulatory capital requirements and maintain sufficient liquidity, including liquidity at the Company, as well as the Bank. If we fail to meet these capital and other regulatory requirements, including more rigorous requirements arising from our regulators' implementation of Basel III, our financial condition, liquidity and results of operations would be materially and adversely affected. Our failure to remain well capitalized and well managed, including meeting the Basel III capital conservation buffers, for bank regulatory purposes could affect customer confidence, our ability to grow, our costs of funds and FDIC insurance, our ability to raise brokered deposits, our ability to pay dividends on our common stock and our ability to make acquisitions, and we would no longer meet the requirements for becoming a financial holding company. These could also affect our ability to use discretionary bonuses to attract and retain quality people.

*The Dodd-Frank Act currently restricts our future issuance of trust preferred securities and cumulative preferred securities as eligible Tier 1 risk-based capital for purposes of the regulatory capital guidelines for bank holding companies.*

While banks and thrift holding companies with assets of less than \$15 billion as of December 31, 2009 are permitted to include trust preferred securities that were issued before May 19, 2010 as Tier 1 capital under the Dodd-Frank Act, only bank holding companies with assets of less than \$500 million are permitted to continue to issue trust preferred securities and have them count as Tier 1 capital. Accordingly, should we determine it is advisable, or should our regulators require us, based upon new capital or liquidity regulations or otherwise, to raise additional Tier 1 risk-based

capital, unless we qualified under the new Small BHC policy, we would not be able to issue additional trust preferred securities or Company senior or secured debt, the proceeds of which could be downstreamed as capital to the Bank. Instead, we would have to issue noncumulative preferred stock or common equity. To the extent we issue new equity, it could result in dilution to our shareholders. To the extent we issue preferred stock, dividends on the preferred stock, unlike distributions paid on trust preferred securities, would not be tax deductible, and the preferred stock would have a preference in liquidation and in dividends to our common stock.

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*We may need to raise additional capital in the future, but that capital may not be available when it is needed or on favorable terms.*

We anticipate that our current capital resources will satisfy our capital requirements for the foreseeable future under currently effective rules. We may, however, need to raise additional capital to support our growth or currently unanticipated losses, or to meet the needs of our communities, resulting from failures or cutbacks by our competitors, and the Basel III Rules. Our ability to raise additional capital, if needed, will depend, among other things, on conditions in the capital markets at that time, which are limited by events outside our control, and on our financial performance. If we cannot raise additional capital on acceptable terms when needed, our ability to further expand our operations through internal growth and acquisitions could be limited.

*Future acquisitions and expansion activities may disrupt our business, dilute shareholder value and adversely affect our operating results.*

We regularly evaluate potential acquisitions and expansion opportunities, including new branches and other offices. To the extent that we grow through acquisitions, we cannot assure you that we will be able to adequately or profitably manage this growth. Acquiring other banks, branches, or businesses, as well as other geographic and product expansion activities, involve various risks including:

risks of unknown or contingent liabilities;

unanticipated costs and delays;

risks that acquired new businesses will not perform consistent with our growth and profitability expectations;

risks of entering new markets or product areas where we have limited experience;

risks that growth will strain our infrastructure, staff, internal controls and management, which may require additional personnel, time and expenditures;

exposure to potential asset quality issues with acquired institutions;

difficulties, expenses and delays of integrating the operations and personnel of acquired institutions;

potential disruptions to our business;

possible loss of key employees and customers of acquired institutions;

potential short-term decreases in profitability; and

diversion of our management's time and attention from our existing operations and business.

*Attractive acquisition opportunities may not be available to us in the future.*

While we seek continued organic growth, we also may consider the acquisition of other businesses. We expect that other banking and financial companies, many of which have significantly greater resources, will compete with us to acquire financial services businesses. This competition could increase prices for potential acquisitions that we believe are attractive. Also, acquisitions are subject to various regulatory approvals. If we fail to receive the appropriate regulatory approvals, we will not be able to consummate an acquisition that we believe is in our best interests, and regulatory approvals could contain conditions that reduce the anticipated benefits of any transaction. Among other things, our regulators consider our capital, liquidity, profitability, regulatory compliance and levels of goodwill and intangibles when considering acquisition and expansion proposals. Any acquisition could be dilutive to our earnings and shareholders' equity per share of our common stock.

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*Technological changes affect our business, and we may have fewer resources than many competitors to invest in technological improvements.*

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to serving clients better, the effective use of technology may increase efficiency and may enable financial institutions to reduce costs. Our future success will depend, in part, upon our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in operations, while avoiding cyber attacks and disruptions, and data breaches. We may need to make significant additional capital investments in technology, including cyber and data security, and we may not be able to effectively implement new technology-driven products and services, or such technology may prove less effective than sought. Many competitors have substantially greater resources to invest in technological improvements and, increasingly, non-banking firms are using technology to compete with traditional lenders for loans and other banking services.

*Our information systems may experience an interruption or security breach.*

We rely heavily on communications and information systems, including those provided by third-party service providers, to conduct our business. Any failure, interruption, or security breach of these systems could result in failures or disruptions which could affect our customers' privacy and our customer relationships, generally. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption, cyber-attack, or security breaches, there is no assurance that these events will not occur and, if they do occur, that they will be adequately addressed without undue effects on our business, including loss of customers and added costs. In addition to the immediate costs of any failure, interruption or security breach, including those at our third-party service providers, these events could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations. Cyber attacks are increasing in general, and are a regulatory and business focus, as is vendor management for third parties who supply us with services, including information technology and customer products.

*Severe weather, natural disasters, acts of war or terrorism or other external events could have significant effects on our business.*

Severe weather and natural disasters, including hurricanes, tornados, drought and floods, acts of war or terrorism or other external events could have a significant effect on our ability to conduct business. Such events could affect the stability of our deposit base; impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

*Our ability to continue to pay dividends to shareholders in the future is subject to profitability, capital, liquidity and regulatory requirements and these limitations may prevent us from paying dividends in the future.*

Cash available to pay dividends to our shareholders is derived primarily from dividends paid to the Company by the Bank. The ability of the Bank to pay dividends, as well as our ability to pay dividends to our shareholders, will continue to be subject to and limited by the results of operations of our subsidiaries and our need to maintain appropriate liquidity and capital at all levels of our business consistent with regulatory requirements and the needs of our businesses. *See* Supervision and Regulation .

*A limited trading market exists for our common shares, which could lead to price volatility.*

Your ability to sell or purchase common shares depends upon the existence of an active trading market for our common stock. Although our common stock is quoted on the Nasdaq Global Market, the volume of trades on any given day has been limited historically. As a result, you may be unable to sell or purchase shares of our common stock at the volume, price and time that you desire. Additionally, whether the purchase or sales prices of our common stock reflects a reasonable valuation of our common stock also is affected by an active trading market, and thus the price you receive for a thinly-traded stock such as common stock, may not reflect its true or intrinsic value. The limited trading market for our common stock may cause fluctuations in the market value of our common stock to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

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**ITEM 2. DESCRIPTION OF PROPERTY**

The Bank conducts its business from its main office and nine full-service branches. The Bank also operates a commercial loan production office in Phenix City, Alabama. The bank owns its main office building, which is located in downtown Auburn, Alabama, and has approximately 16,150 square feet of space. The original building was constructed in 1964, and an addition was completed in 1981. Portions of the building have been renovated to accommodate growth and changes in the Bank's operational structure and to adapt to technological changes. The main office offers the full line of the Bank's services and has one ATM. The Bank completed construction on a new drive-through facility located on the main office campus in October 2012. This drive-through facility has five drive-through lanes, including an ATM, and a walk-up teller window.

The Bank also owns a commercial office building, the AuburnBank Center (the Center), which is located next to the Bank's main office. The Center has approximately 23,000 square feet of space. The Bank's mortgage division, data processing activities, as well as other operations, are located in the Center. In total, the main office and Center parking lots provide parking for approximately 196 vehicles.

The Opelika branch is located in Opelika, Alabama. This branch, built in 1991, is owned by the Bank and has approximately 4,000 square feet of space. This branch offers the full line of the Bank's services and has drive-through windows and an ATM. This branch offers parking for approximately 36 vehicles.

The Bank's Notasulga branch was opened in August 2001. This branch is located in Notasulga, Alabama, about 15 miles south of Auburn, Alabama. This branch is owned by the Bank and has approximately 1,344 square feet of space. The Bank leased the land for this branch from a third party. In May 2015, the Bank's land lease renewed for another three year term. This branch offers the full line of the Bank's services including safe deposit boxes and a drive-through window. This branch offers parking for approximately 11 vehicles, including a handicapped ramp.

In July 2002, the Bank's Opelika Wal-Mart Supercenter branch was opened inside the Wal-Mart shopping center in Opelika, Alabama. In June 2012, the Bank exercised its option to extend the lease for another five years. The lease is for approximately 700 square feet of space in the Wal-Mart. This branch offers the full line of the Bank's deposits and other services including an ATM, except safe deposit boxes.

In November 2002, the Bank opened a loan production office in Phenix City, Alabama, about 35 miles south of Auburn, Alabama. In November 2015, the Bank renewed its lease for another year.

In July 2007, the Bank opened a new branch located in the Kroger supermarket in the TigerTown retail center in Opelika, Alabama. The Bank entered into a lease agreement with the Kroger Corporation for five years with options for two 5-year extensions. In July 2012, the Bank exercised its option to extend the lease for another five years. The Branch offers the full line of bank deposit and other services including an ATM, except for safe deposit boxes.

In February 2009, the Bank opened a branch located on Bent Creek Road in Auburn, Alabama. This branch is owned by the Bank and has approximately 4,000 square feet of space. This branch offers the full line of the Bank's services and has drive-through windows and a drive-up ATM. This branch offers parking for approximately 29 vehicles.

In December 2011, the Bank opened a branch located on Fob James Drive in Valley, Alabama, about 30 miles northeast of Auburn, Alabama. This branch is owned by the Bank and has approximately 5,000 square feet of space. This branch offers the full line of the Bank's services and has drive-through windows and a drive-up ATM. This branch offers parking for approximately 35 vehicles. Prior to December 2011, the Bank leased office space for a loan production office in Valley, Alabama. The loan production office was originally opened in September 2004.

In February 2015, the Bank relocated its Auburn Kroger branch to a new location within the Corner Village Shopping Center, in Auburn, Alabama. In February 2015, the Bank entered into a new lease agreement for five years with options for two 5-year extensions. The Bank leases approximately 1,500 square feet of space for the Corner Village branch. Prior to relocation, the Bank's Auburn Kroger branch was located in the Kroger supermarket in the same shopping center. The Auburn Kroger branch was originally opened in August 1988. The Corner Village branch offers the full line of the Bank's deposit and other services including an ATM, except safe deposit boxes.

In September 2015, the Bank relocated its Auburn Wal-Mart Supercenter branch to a new location the Bank purchased in December 2014 at the intersection of S. Donahue Avenue and E. University Drive in Auburn, Alabama. The South Donahue branch, built in 2015, has approximately 3,600 square feet of space. Prior to relocation, the Bank's Auburn Wal-Mart Supercenter branch was located inside the Wal-Mart shopping center on the south side of Auburn, Alabama. The Auburn Wal-Mart Supercenter branch was originally opened in September 2000. The South Donahue branch offers the full line of the Bank's services and has drive-through windows and an ATM. This branch offers parking for approximately 28 vehicles.



**Table of Contents****ITEM 3 LEGAL PROCEEDINGS**

In the normal course of its business, the Company and the Bank from time to time are involved in legal proceedings. The Company's management believe there are no pending or threatened legal proceedings that, upon resolution, are expected to have a material adverse effect upon the Company's or the Bank's financial condition or results of operations.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

The Company's Common Stock is listed on the Nasdaq Global Market, under the symbol AUBN. As of March 9, 2016, there were approximately 3,643,478 shares of the Company's Common Stock issued and outstanding, which were held by approximately 416 shareholders of record. The following table sets forth, for the indicated periods, the high and low closing sale prices for the Company's Common Stock as reported on the Nasdaq Global Market, and the cash dividends declared to shareholders during the indicated periods.

	Closing Price Per Share (1)		Cash Dividends Declared
	High	Low	
<b>2015</b>			
First Quarter	\$ 25.25	\$ 23.15	\$ 0.22
Second Quarter	25.75	24.51	0.22
Third Quarter	27.80	25.78	0.22
Fourth Quarter	30.39	26.14	0.22
<b>2014</b>			
First Quarter	\$ 25.80	\$ 23.20	\$ 0.215
Second Quarter	25.00	22.90	0.215
Third Quarter	24.92	23.17	0.215
Fourth Quarter	24.64	22.10	0.215

(1) The price information represents actual transactions.

The Company has paid cash dividends on its capital stock since 1985. Prior to this time, the Bank paid cash dividends since its organization in 1907, except during the Depression years of 1932 and 1933. Holders of Common Stock are entitled to receive such dividends as may be declared by the Company's Board of Directors. The amount and frequency of cash dividends will be determined in the judgment of the Board based upon a number of factors, including the Company's earnings, financial condition, capital requirements and other relevant factors. The Board currently intends to continue its present dividend policies.

Federal Reserve policy could restrict future dividends on our Common Stock, depending on our earnings and capital position and likely needs. See [Supervision and Regulation](#) [Payment of Dividends](#) and [Management's Discussion and Analysis of Financial Condition and Results of Operations](#) [Capital Adequacy](#) .

The amount of dividends payable by the Bank is limited by law and regulation. The need to maintain adequate capital in the Bank also limits dividends that may be paid to the Company.

**Table of Contents****Performance Graph**

The following performance graph compares the cumulative, total return on the Company's Common Stock from December 31, 2010 to December 31, 2015, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a \$100 investment on December 31, 2010). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.

<i>Index</i>	<i>Period Ending</i>					
	<b>12/31/10</b>	<b>12/31/11</b>	<b>12/31/12</b>	<b>12/31/13</b>	<b>12/31/14</b>	<b>12/31/15</b>
Auburn National Bancorporation, Inc.	100.00	96.14	112.20	139.52	136.64	177.07
NASDAQ Composite	100.00	99.21	116.82	163.75	188.03	201.40
SNL Southeast Bank	100.00	58.51	97.19	131.70	148.33	146.02

**ISSUER PURCHASES OF EQUITY SECURITIES**

Not applicable.

**Securities Authorized for Issuance Under Equity Compensation Plans**

See the information included under Part III, Item 12, which is incorporated in response to this item by reference.

**ITEM 6. SELECTED FINANCIAL DATA**

See Table 2 Selected Financial Data and general discussion in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following is a discussion of our financial condition at December 31, 2015 and 2014 and our results of operations for the years ended December 31, 2015 and 2014. The purpose of this discussion is to provide information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein. In addition, this discussion and analysis contains forward-looking statements, so you should refer to Item 1A, Risk Factors and Special Cautionary Notice Regarding Forward-Looking Statements .

**OVERVIEW**

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

**Summary of Results of Operations**

	<b>Year ended December 31</b>	
	<b>2015</b>	<b>2014</b>
<i>(Dollars in thousands, except per share data)</i>		
Net interest income (a)	\$ 24,060	\$ 22,741
Less: tax-equivalent adjustment	1,342	1,288
Net interest income (GAAP)	22,718	21,453
Noninterest income	4,532	3,933
Total revenue	27,250	25,386
Provision for loan losses	200	50
Noninterest expense	16,372	15,104
Income tax expense	2,820	2,784
Net earnings	\$ 7,858	\$ 7,448
Basic and diluted earnings per share	\$ 2.16	\$ 2.04

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

**Financial Summary**

The Company's net earnings were \$7.9 million, or \$2.16 per share, for the full year 2015, compared to \$7.4 million, or \$2.04 per share, for the full year 2014.

Net interest income (tax-equivalent) was \$24.1 million in 2015, compared to \$22.7 million in 2014. The increase was primarily due to a reduction in interest expense as the Company repaid higher-cost wholesale funding sources and lowered its deposit costs. Additionally, the Company continued its efforts to increase earnings by shifting its asset mix through loan growth. Net interest income (tax-equivalent) for 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 \$23.9 million for 2015, an increase of 5% compared to 2014.

The provision for loan losses was \$0.2 million in 2015, compared to \$0.1 million in 2014. The increase in the provision for loan losses was primarily due to a slight increase in net charge-offs. Net charge-offs were \$0.7 million, or 0.18% of average loans, in 2015, compared to \$0.5 million, or 0.12% of average loans, in 2014. Overall, the level of allowance decreased due to a decrease in adversely classified loans and historical loss rates used in the allowance for loan loss calculation.

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Noninterest income was \$4.5 million in 2015, compared to \$3.9 million in 2014. The increase in noninterest income was due to several factors, including an increase in net gains (losses) on securities of \$0.5 million, the Company had a net gain of \$16 thousand in 2015 compared to \$0.5 million net loss, including other-than-temporary impairment in 2014, and an increase in income from bank owned life insurance of \$0.2 million. These increases were partially offset by a decrease in mortgage lending of \$0.2 million as servicing fees, net of related amortization expense declined.

Noninterest expense was \$16.4 million in 2015, compared to \$15.1 million in 2014. The increase was primarily due to an \$11 thousand loss on other real estate owned in 2015 compared to a \$0.5 million gain in 2014, a prepayment penalty on long-term debt of \$0.4 million in 2015 when the Company repaid \$5.0 million long-term debt with a weighted average interest rate of 3.59% compared to no prepayment penalties on long-term debt in 2014; and an increase of \$0.4 million in salaries and benefits.

Income tax expense was \$2.8 million in 2015 and 2014. The Company's effective income tax rate was 26.41% in 2015, compared to 27.21% in 2014. The Company's effective income tax rate decreased primarily due to an increase in tax-exempt interest income on municipal securities and income from bank owned life insurance.

In 2015, the Company paid cash dividends of \$3.2 million, or \$0.88 per share. The Company remains well capitalized under current regulatory guidelines with a total risk-based capital ratio of 17.44%, a Tier 1 risk-based capital ratio of 16.57%, a Tier 1 leverage capital ratio of 10.35% and a Common Equity Tier 1 ( CET1 ) capital ratio of 15.28% at December 31, 2015.

## **CRITICAL ACCOUNTING POLICIES**

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

### **Allowance for Loan Losses**

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

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

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

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

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

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

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

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

The Company regularly re-evaluates its practices in determining the allowance for loan losses. 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 began calculating average losses for all loan segments using a rolling 20 quarter historical period and continued this methodology through December 31, 2015. 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).

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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 17, Fair Value, of the consolidated financial statements that accompany this report.

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

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

## **Other Real Estate Owned**

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

## **Deferred Tax Asset Valuation**

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of taxable income over the last three years and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at December 31, 2015. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

**Table of Contents****Average Balance Sheet and Interest Rates**

	2015		Year ended December 31 2014	
	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
<i>(Dollars in thousands)</i>				
Loans and loans held for sale	\$ 413,616	4.95%	\$ 388,373	5.03%
Securities - taxable	186,845	2.06%	207,655	2.23%
Securities - tax-exempt (a)	68,386	5.77%	62,870	6.03%
Total securities	255,231	3.05%	270,525	3.11%
Federal funds sold	58,607	0.23%	56,110	0.19%
Interest bearing bank deposits	31,028	0.25%	6,559	0.43%
Total interest-earning assets	758,482	3.76%	721,567	3.89%
Deposits:				
NOW	115,146	0.30%	105,533	0.31%
Savings and money market	215,936	0.39%	191,882	0.51%
Certificates of deposits less than \$100,000	91,136	1.03%	101,561	1.15%
Certificates of deposits and other time deposits of \$100,000 or more	140,831	1.43%	156,029	1.57%
Total interest-bearing deposits	563,049	0.73%	555,005	0.89%
Short-term borrowings	3,601	0.50%	3,814	0.50%
Long-term debt	8,286	3.40%	12,217	3.42%
Total interest-bearing liabilities	574,936	0.77%	571,036	0.94%
Net interest income and margin (a)	\$ 24,060	3.17%	\$ 22,741	3.15%

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

**RESULTS OF OPERATIONS****Net Interest Income and Margin**

Net interest income (tax-equivalent) was \$24.1 million in 2015, compared to \$22.7 million in 2014. The increase reflects management's continuing 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 2015 included \$0.2 million in recoveries of interest related to payoffs recorded on two loans that were previously impaired. Excluding the impact of these interest recoveries, net interest income (tax-equivalent) would have been \$23.9 million for 2015, an increase of 5% compared to 2014.

The tax-equivalent yield on total interest-earning assets decreased by 13 basis points in 2015 from 2014 to 3.76%. The 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 the yields on new and renewed loans.

The cost of total interest-bearing liabilities decreased 17 basis points in 2015 from 2014 to 0.77%. The net decrease was largely the 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 pricing competition for quality loan opportunities, and fewer opportunities to further 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, in management's evaluation, should be adequate to provide coverage for the probable losses on outstanding loans. The provision for loan losses amounted to \$0.2 million and \$0.1 million for the years ended December 31, 2015 and 2014, respectively.

The increase was primarily due to a slight increase in net charge-offs. Net charge-offs were \$0.7 million, or 0.18% of average loans and \$0.5 million, or 0.12% of average loans, for the years ended December 31, 2015 and 2014, respectively.

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Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes to be appropriate to adequately cover probable losses in the loan portfolio. The Company's allowance for loan losses to total loans decreased to 1.01% at December 31, 2015 from 1.20% at December 31, 2014. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2015. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are believed adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgment and are therefore approximate and imprecise. Factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions exist which may negatively and materially affect our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

**Noninterest Income**

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>	
	<b>2015</b>	<b>2014</b>
Service charges on deposit accounts	\$ 823	\$ 872
Mortgage lending	1,444	1,636
Bank-owned life insurance	747	501
Securities gains (losses), net	16	(530)
Other	1,502	1,454
<b>Total noninterest income</b>	<b>\$ 4,532</b>	<b>\$ 3,933</b>

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

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

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

The Company evaluates MSRs for impairment on a quarterly basis. Impairment is determined by grouping MSRs by common predominant characteristics, such as interest rate and loan type. If the aggregate carrying amount of a particular group of MSRs exceeds the group's aggregate fair value, a valuation allowance for that group is established. The valuation allowance is adjusted as the fair value changes. An increase in mortgage interest rates typically results in an increase in the fair value of the MSRs while a decrease in mortgage interest rates typically results in a decrease in the fair value of MSRs.

The following table presents a breakdown of the Company's mortgage lending income for 2015 and 2014.

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>	
	<b>2015</b>	<b>2014</b>
Origination income	\$ 1,152	\$ 1,163
Servicing fees, net	239	526
Decrease (increase) in MSR valuation allowance	53	(53)
<b>Total mortgage lending income</b>	<b>\$ 1,444</b>	<b>\$ 1,636</b>

The decrease in mortgage lending income was primarily due to a decrease in servicing fees, net of related amortization expense. Although servicing fees were largely unchanged, amortization expense increased due to faster prepayments.

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Income from bank-owned life insurance increased in 2015, compared to 2014 due to non-taxable death benefits received. The assets that support these policies are administered by the life insurance carriers and the income we receive (i.e. increases or decreases in the cash surrender value of the policies) on these policies is dependent upon the returns the insurance carriers are able to earn on the underlying investments that support these policies. Earnings on these policies are generally not taxable.

Net securities gains (losses) consist of realized gains and losses on the sale of securities and other-than-temporary impairment charges. Net gains realized on the sale of securities were \$16 thousand for 2015, compared to net losses realized on the sale of securities of \$197 thousand for 2014. The Company recorded an other-than-temporary impairment charge of \$333 thousand in the first quarter of 2014 related to securities that management intended to sell at March 31, 2014. Subsequent to March 31, 2014, the Company sold available-for-sale agency residential mortgage-backed securities ( RMBS ) with a fair value of \$18.9 million and realized the expected loss of approximately \$333 thousand. The Company did not incur any other-than-temporary impairment charges in 2015.

**Noninterest Expense**

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>	
	<b>2015</b>	<b>2014</b>
Salaries and benefits	\$ 9,293	\$ 8,943
Net occupancy and equipment	1,547	1,431
Professional fees	756	920
FDIC and other regulatory assessments	472	465
Other real estate owned, net	11	(450)
Prepayment penalties on long-term debt	362	
Other	3,931	3,795
Total noninterest expense	\$ 16,372	\$ 15,104

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

The increase in net occupancy and equipment expense reflects increases in various items, including repairs and maintenance and depreciation expense.

FDIC and other regulatory assessments expense was largely unchanged as growth in the Bank's total assessment base (average total assets minus tangible equity) offset a decrease in the Bank's quarterly assessment rate as several variables utilized by the FDIC in calculating our deposit insurance assessment improved.

The increase in OREO expense, net was primarily due to gains realized on the sale of certain OREO properties during 2014.

The Company repaid \$5.0 million of long-term debt during 2015 with a weighted average interest rate of 3.59% and incurred prepayment penalties of \$0.4 million.

Other noninterest expense increased in 2015, compared to 2014 due to various items, including software expense.



## **Income Tax Expense**

Income tax expense was \$2.8 million in 2015 and 2014. The Company's effective income tax rate was 26.41% in 2015, compared to 27.21% in 2014. The Company's effective income tax rate decreased primarily due to an increase in tax-exempt interest income on municipal securities and income from bank owned life insurance.

## **BALANCE SHEET ANALYSIS**

### **Securities**

Securities available-for-sale were \$241.7 million at December 31, 2015, a decrease of \$25.9 million, or 9.7%, compared to \$267.6 million as of December 31, 2014. This decline was primarily due to a decrease of \$25.1 million in the amortized cost basis of securities available-for-sale as proceeds from principal repayments on mortgage-backed securities were not reinvested. The average tax-equivalent yields earned on total securities were 3.05% in 2015 and 3.11% in 2014.

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The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2015 according to contractual maturity. Actual maturities may differ from contractual maturities of residential mortgage-backed securities ( RMBS ) because the mortgages underlying the securities may be called or prepaid with or without penalty.

	<b>December 31, 2015</b>				
	<b>1 year</b>	<b>1 to 5</b>	<b>5 to 10</b>	<b>After 10</b>	<b>Total</b>
<i>(Dollars in thousands)</i>	<b>or less</b>	<b>years</b>	<b>years</b>	<b>years</b>	<b>Fair Value</b>
Agency obligations	\$ 5,000	25,852	19,463	9,770	60,085
Agency RMBS		1,623	13,511	95,820	110,954
State and political subdivisions		497	12,094	58,057	70,648
Total available-for-sale	\$ 5,000	27,972	45,068	163,647	241,687
<b>Weighted average yield:</b>					
Agency obligations	0.45%	1.75%	2.44%	3.00%	2.07%
Agency RMBS			2.02%	2.38%	2.28%
State and political subdivisions		4.30%	4.01%	3.67%	3.74%
Total available-for-sale	0.45%	1.81%	2.85%	2.82%	2.66%

**Loans**

	<b>December 31</b>				
<i>(In thousands)</i>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Commercial and industrial	\$ 52,479	54,329	57,780	59,334	54,988
Construction and land development	43,694	37,298	36,479	37,631	39,814
Commercial real estate	203,853	192,006	174,920	183,611	162,435
Residential real estate	116,673	107,641	101,706	105,631	101,725
Consumer installment	10,220	12,335	12,893	12,219	11,454
Total loans	426,919	403,609	383,778	398,426	370,416
Less: unearned income	(509)	(655)	(439)	(233)	(153)
Loans, net of unearned income	\$ 426,410	402,954	383,339	398,193	370,263

Total loans, net of unearned income, were \$426.4 million at December 31, 2015, an increase of \$23.5 million, or 6%, from \$403.0 million at December 31, 2014. Four loan categories represented the majority of the loan portfolio at December 31, 2015: commercial real estate mortgage loans (48%), residential real estate mortgage loans (27%), commercial and industrial loans (12%) and construction and land development loans (10%). Approximately 23% of the Company's commercial real estate loans were classified as owner-occupied at December 31, 2015.

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately \$16.4 million, or 4%, and \$16.5 million, or 4%, of total loans, net of unearned income at December 31, 2015 and 2014, respectively. For residential real estate mortgage loans with a consumer purpose, approximately \$0.9 million and \$1.9 million required interest-only payments at December 31, 2015 and 2014, respectively. The Company's residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high-risk consumer mortgage products.

Purchased loan participations included in the Company's loan portfolio were approximately \$1.4 million and \$1.5 million as of December 31, 2015 and 2014, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company's normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures described under Critical Accounting Policies Allowance for Loan Losses .

The average yield earned on loans and loans held for sale was 4.95% in 2015 and 5.03% in 2014.

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the effects of current economic conditions on our borrowers' cash flows, real estate market sales volumes, valuations, and availability and cost of financing for properties, real estate industry concentrations, deterioration in certain credits, interest rate fluctuations, reduced collateral values or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and any violation of applicable laws and regulations.

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The Company attempts to reduce these economic and credit risks by adhering to loan to value guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers' financial positions. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit a bank's credit exposure by prohibiting unsecured loan relationships that exceed 10% of its capital accounts; or 20% of capital accounts, if loans in excess of 10% are fully secured. Under these regulations, we are prohibited from having secured loan relationships in excess of approximately \$17.5 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$15.7 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At December 31, 2015, the Bank had no loan relationships exceeding this limit.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any one or more industries. We use classification systems broadly accepted by the financial services industry in order to categorize our commercial borrowers. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank's total risk-based capital at December 31, 2015 (and related balances at December 31, 2014).

	<b>December 31</b>	
<i>(In thousands)</i>	<b>2015</b>	<b>2014</b>
Lessors of 1-4 family residential properties	\$ 46,664	\$ 41,152
Multi-family residential properties	45,264	35,961
Shopping centers	38,116	30,016

**Allowance for Loan Losses**

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company's estimate of probable losses in the loan portfolio. As of December 31, 2015 and 2014, respectively, the allowance for loan losses was \$4.3 million and \$4.8 million, respectively, which management believed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under **Critical Accounting Policies**.

A summary of the changes in the allowance for loan losses and certain asset quality ratios for each of the five years in the five year period ended December 31, 2015 is presented below.

	<b>Year ended December 31</b>				
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 4,836	5,268	6,723	6,919	7,676
<b>Charge-offs:</b>					
Commercial and industrial	(100)	(46)	(514)	(289)	(679)
Construction and land development		(235)	(39)	(231)	(1,758)

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Commercial real estate	(866)		(262)	(3,184)	(422)
Residential real estate	(89)	(438)	(808)	(545)	(533)
Consumer installment	(59)	(89)	(397)	(85)	(21)
<b>Total charge-offs</b>	<b>(1,114)</b>	<b>(808)</b>	<b>(2,020)</b>	<b>(4,334)</b>	<b>(3,413)</b>
Recoveries:					
Commercial and industrial	22	71	48	54	34
Construction and land development	17	8	6	46	2
Commercial real estate		119	4	71	
Residential real estate	313	112	88	134	155
Consumer installment	15	16	19	18	15
<b>Total recoveries</b>	<b>367</b>	<b>326</b>	<b>165</b>	<b>323</b>	<b>206</b>
<b>Net charge-offs</b>	<b>(747)</b>	<b>(482)</b>	<b>(1,855)</b>	<b>(4,011)</b>	<b>(3,207)</b>
Provision for loan losses	200	50	400	3,815	2,450
<b>Ending balance</b>	<b>\$ 4,289</b>	<b>4,836</b>	<b>5,268</b>	<b>6,723</b>	<b>6,919</b>
as a % of loans	1.01 %	1.20	1.37	1.69	1.87
as a % of nonperforming loans	158 %	433	124	64	67
Net charge-offs as a % of average loans	0.18 %	0.12	0.48	1.03	0.86

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As noted under **Critical Accounting Policies**, management assesses the adequacy of the allowance prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.01% at December 31, 2015, compared to 1.20% at December 31, 2014. The improvement in the allowance for loan losses to total loans outstanding was attributable to both a decrease in historical loss rates and a reduction in adversely classified loans. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken.

Net charge-offs were \$0.7 million, or 0.18% of average loans, in 2015, compared to net charge-offs of \$0.5 million, or 0.12%, in 2014. 78% of gross charge-offs in 2015 related to two nonperforming commercial real estate loans. With the exception of the commercial and industrial and commercial real estate portfolio segments, all loan segments experienced a decline in net charge-offs in 2015.

At December 31, 2015 and 2014, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 158% and 433%, respectively. The decrease was primarily due to an increase in nonperforming loans of \$1.6 million in 2015, with no corresponding valuation allowances at December 31, 2015.

At December 31, 2015 and 2014, the Company's recorded investment in loans considered impaired was \$3.4 million and \$3.3 million, respectively, with corresponding valuation allowances (included in the allowance for loan losses) of \$0.1 million and \$0.2 million at each respective date.

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

**Nonperforming Assets**

At December 31, 2015 the Company had \$3.0 million in nonperforming assets compared to \$1.7 million at December 31, 2014. Nonperforming assets increased during 2015 due primarily to one nonperforming commercial real estate loan with a recorded investment of \$1.5 million at December 31, 2015.

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

				<b>December 31</b>		
<i>(Dollars in thousands)</i>		<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
<b>Nonperforming assets:</b>						
Nonperforming (nonaccrual) loans	\$	2,714	1,117	4,261	10,535	10,354
Other real estate owned		252	534	3,884	4,919	7,898
Total nonperforming assets	\$	2,966	1,651	8,145	15,454	18,252

as a % of loans and other real estate owned	0.70 %	0.41	2.10	3.83	4.83
as a % of total assets	0.36 %	0.21	1.08	2.03	2.35
Nonperforming loans as a % of total loans	0.64 %	0.28	1.11	2.65	2.80
Accruing loans 90 days or more past due	\$		73	58	

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The table below provides information concerning the composition of nonaccrual loans at December 31, 2015 and 2014, respectively.

<i>(In thousands)</i>	<b>2015</b>	<b>December 31 2014</b>
<b>Nonaccrual loans:</b>		
Commercial and industrial	\$ 43	55
Construction and land development	583	605
Commercial real estate	1,750	263
Residential real estate	325	194
Consumer installment	13	
<b>Total nonaccrual loans / nonperforming loans</b>	<b>\$ 2,714</b>	<b>1,117</b>

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At December 31, 2015, the Company had \$2.7 million in loans on nonaccrual, compared to \$1.1 million at December 31, 2014.

Due to the weakening credit status of a borrower, the Company may elect to formally restructure certain loans to facilitate a repayment plan that minimizes the potential losses that we might incur. Restructured loans, or troubled debt restructurings ( TDRs ), are classified as impaired loans, and if the loans are on nonaccrual status as of the date of restructuring, the loans are included in the nonaccrual loan balances noted above. Nonaccrual loan balances do not include loans that have been restructured that were performing as of the restructure date. At December 31, 2015 and 2014, the Company had \$1.1 million and \$2.2 million, respectively, in accruing TDRs.

At December 31, 2015 and 2014, there were no loans 90 days past due and still accruing interest.

The table below provides information concerning the composition of OREO at December 31, 2015 and 2014, respectively.

<i>(In thousands)</i>	<b>2015</b>	<b>December 31 2014</b>
<b>Other real estate owned:</b>		
Commercial:		
Developed lots	252	252
Residential		282
<b>Total other real estate owned</b>	<b>\$ 252</b>	<b>534</b>

At December 31, 2015, the Company held \$0.3 million in OREO, which was acquired from borrowers compared to \$0.5 million at December 31, 2014.



**Potential Problem Loans**

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Federal Reserve, the Company's primary regulator, for loans classified as substandard, excluding nonaccrual loans. Potential problem loans, which are not included in nonperforming assets, amounted to \$5.9 million, or 1.4% of total loans at December 31, 2015, compared to \$7.8 million, or 1.9% of total loans at December 31, 2014.

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The table below provides information concerning the composition of potential problem loans at December 31, 2015 and 2014, respectively.

<i>(In thousands)</i>	<b>2015</b>	<b>December 31 2014</b>
<b>Potential problem loans:</b>		
Commercial and industrial	\$ 323	376
Construction and land development	593	556
Commercial real estate	491	884
Residential real estate	4,371	5,917
Consumer installment	114	114
<b>Total potential problem loans</b>	<b>\$ 5,892</b>	<b>7,847</b>

At December 31, 2015, approximately \$0.8 million or 13.3% of total potential problem loans were past due at least 30 but less than 90 days. At December 31, 2015, the remaining balance of potential problem loans were current or past due less than 30 days.

The following table is a summary of the Company's performing loans that were past due at least 30 days but less than 90 days as of December 31, 2015 and 2014, respectively.

<i>(In thousands)</i>	<b>2015</b>	<b>December 31 2014</b>
<b>Performing loans past due 30 to 89 days:</b>		
Commercial and industrial	\$ 49	168
Construction and land development		210
Commercial real estate		201
Residential real estate	1,334	2,231
Consumer installment	28	45
<b>Total performing loans past due 30 to 89 days</b>	<b>\$ 1,411</b>	<b>2,855</b>

**Deposits****December 31**

<i>(In thousands)</i>	<b>2015</b>	<b>2014</b>
Noninterest bearing demand	\$ 156,817	130,160
NOW	118,998	111,243
Money market	183,042	163,237
Savings	45,172	39,624
Certificates of deposit under \$100,000	85,427	96,890
Certificates of deposit and other time deposits of \$100,000 or more	123,740	135,722
Brokered certificates of deposit	10,431	16,514
 Total deposits	 \$ 723,627	 693,390

Total deposits were \$723.6 million and \$693.4 million at December 31, 2015 and 2014, respectively. The increase in total deposits of \$30.2 million and the change in deposit mix reflect customer preferences for short-term instruments in a low interest rate environment.

The average rates paid on total interest-bearing deposits were 0.73% in 2015 and 0.89% in 2014. Noninterest bearing deposits were 22% and 19% of total deposits at both December 31, 2015 and 2014, respectively.

### **Other Borrowings**

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity of one year or less. The Bank had available federal fund lines totaling \$41.0 million with none outstanding at December 31, 2015, compared to \$38.0 million with none outstanding at December 31, 2014. Securities sold under agreements to repurchase totaled \$3.0 million and \$4.7 million at December 31, 2015 and 2014, respectively.

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The average rates paid on short-term borrowings were 0.50% in both 2015 and 2014. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the two-year period ended December 31, 2015 is included in Note 10 to the accompanying consolidated financial statements included in this annual report.

Long-term debt includes FHLB advances with an original maturity greater than one year and subordinated debentures related to trust preferred securities. At December 31, 2015 the company had no long-term FHLB advances outstanding compared to \$5.0 million at December 31, 2014. The Company had \$7.2 million in junior subordinated debentures related to trust preferred securities outstanding at December 31, 2015 and 2014. The debentures mature on December 31, 2033 and have been redeemable since December 31, 2008.

The average rates paid on long-term debt were 3.40% in 2015 and 3.42% in 2014.

## **CAPITAL ADEQUACY**

The Company's consolidated stockholders' equity was \$79.9 million and \$75.8 million as of December 31, 2015 and 2014, respectively. The change from December 31, 2014 was primarily driven by net earnings of \$7.9 million, partially offset by cash dividends paid of \$3.2 million and an other comprehensive loss due to the change in unrealized gains (losses) on securities available-for-sale, net-of-tax, of \$0.5 million.

The Company's Tier 1 leverage ratio was 10.35%, Common Equity Tier 1 ( CET1 ) risk-based capital ratio was 15.28%, Tier 1 risk-based capital ratio was 16.57%, and total risk-based capital ratio was 17.44% at December 31, 2015. These ratios exceed the minimum regulatory capital percentages of 5.0% for Tier 1 leverage ratio, 6.5% for CET1 risk-based capital ratio, 8.0% for Tier 1 risk-based capital ratio, and 10.0% for total risk-based capital ratio to be considered well capitalized. Based on current regulatory standards, the Company is classified as well capitalized.

## **MARKET AND LIQUIDITY RISK MANAGEMENT**

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

### **Interest Rate Risk Management**

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates because assets and liabilities may mature or reprice at different times. For example, if liabilities reprice faster than assets, and interest rates are generally rising, earnings will initially decline. In addition, assets and liabilities may reprice at the same time but by different amounts. For example, when the general level of interest rates is rising, the Company may increase rates paid on interest bearing demand deposit accounts and savings deposit accounts by an amount that is less than the general increase in market interest rates. Also, short-term and long-term market interest rates may change by different amounts. For example, a flattening yield curve may reduce the interest spread between new loan yields and funding costs. Further, the remaining maturity of various assets and liabilities may shorten or lengthen as interest rates change. For example, if long-term mortgage interest rates decline sharply, mortgage-backed securities in the securities portfolio may prepay earlier than anticipated, which could reduce earnings. Interest rates may also have a direct or indirect effect on loan demand, loan losses, mortgage origination volume, the fair value of MSR's and other items affecting earnings.

ALCO measures and evaluates the interest rate risk so that we can meet customer demands for various types of loans and deposits. ALCO determines the most appropriate amounts of on-balance sheet and off-balance sheet items. Measurements used to help manage interest rate sensitivity include an earnings simulation and an economic value of equity model.

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**Earnings simulation.** Management believes that interest rate risk is best estimated by our earnings simulation modeling. On at least a quarterly basis, the following 12 month time period is simulated to determine a baseline net interest income forecast and the sensitivity of this forecast to changes in interest rates. The baseline forecast assumes an unchanged or flat interest rate environment. Forecasted levels of earning assets, interest-bearing liabilities, and off-balance sheet financial instruments are combined with ALCO forecasts of market interest rates for the next 12 months and other factors in order to produce various earnings simulations and estimates.

To help limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income from gradual changes in interest rates. For changes up or down in rates from management's flat interest rate forecast over the next 12 months, policy limits for net interest income variances are as follows:

+/- 20% for a gradual change of 400 basis points

+/- 15% for a gradual change of 300 basis points

+/- 10% for a gradual change of 200 basis points

+/- 5% for a gradual change of 100 basis points

The following table reports the variance of net interest income over the next 12 months assuming a gradual change in interest rates up or down when compared to the baseline net interest income forecast at December 31, 2015.

<b>Changes in Interest Rates</b>	<b>Net Interest Income % Variance</b>
400 basis points	4.09 %
300 basis points	2.77
200 basis points	1.96
100 basis points	0.69
(100) basis points	(0.33)
(200) basis points	NM
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2015, our earnings simulation model indicated that we were in compliance with the policy guidelines noted above.

**Economic Value of Equity.** Economic value of equity ( EVE ) measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are estimated by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case EVE. In contrast with our earnings simulation model which evaluates interest rate risk over a 12 month timeframe, EVE uses a terminal horizon which allows for the re-pricing of all assets, liabilities, and off-balance sheet items. Further, EVE is measured using values as of a point in time and does not reflect any actions that ALCO might

take in responding to or anticipating changes in interest rates, or market and competitive conditions.

To help limit interest rate risk, we have stated policy guidelines for an instantaneous basis point change in interest rates, such that our EVE should not decrease from our base case by more than the following:

45% for an instantaneous change of +/- 400 basis points

35% for an instantaneous change of +/- 300 basis points

25% for an instantaneous change of +/- 200 basis points

15% for an instantaneous change of +/- 100 basis points

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The following table reports the variance of EVE assuming an immediate change in interest rates up or down when compared to the baseline EVE at December 31, 2015.

<b>Changes in Interest Rates</b>	<b>EVE % Variance</b>
400 basis points	(16.05) %
300 basis points	(12.01)
200 basis points	(7.90)
100 basis points	(3.07)
(100) basis points	(1.23)
(200) basis points	NM
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2015, our EVE model indicated that we were in compliance with the policy guidelines noted above.

Each of the above analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates, and other economic and market factors, including market perceptions. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types of assets and liabilities may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios in seeking satisfactory, consistent levels of profitability within the framework of the Company's established liquidity, loan, investment, borrowing, and capital policies.

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2015 and 2014, the Company had no derivative contracts to assist in managing interest rate sensitivity.

**Liquidity Risk Management**

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



Liquidity is managed at two levels: at the Company and at the Bank. The management of liquidity at both levels is essential, because the Company and the Bank have different funding needs and sources, are separate legal entities, and each are subject to regulatory guidelines and requirements.

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

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Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB's advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. As of December 31, 2015, the Bank had a remaining available line of credit with the FHLB totaling \$240.6 million. As of December 31, 2015, the Bank also had \$41.0 million of federal funds lines, with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

The following table presents additional information about our contractual obligations as of December 31, 2015, which by their terms had contractual maturity and termination dates subsequent to December 31, 2015:

		Payments due by period			
		1 year or less	1 to 3 years	3 to 5 years	More than 5 years
<i>(Dollars in thousands)</i>	<b>Total</b>				
<b>Contractual obligations:</b>					
Deposit maturities (1)	\$ 723,627	599,640	81,220	42,594	173
Long-term debt	7,217				7,217
Operating lease obligations	413	220	160	33	
<b>Total</b>	<b>\$ 731,257</b>	<b>\$ 599,860</b>	<b>\$ 81,380</b>	<b>\$ 42,627</b>	<b>\$7,390</b>

(1) Deposits with no stated maturity (demand, NOW, money market, and savings deposits) are presented in the 1 year or less column

Management believes that the Company and the Bank have adequate sources of liquidity to meet all known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next 12 months.

**Off-Balance Sheet Arrangements**

At December 31, 2015, the Bank had outstanding standby letters of credit of \$8.2 million and unfunded loan commitments outstanding of \$52.2 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase federal funds from other financial institutions.

*Residential mortgage lending and servicing activities*

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

As of December 31, 2015, the unpaid principal balance of residential mortgage loans, which we have originated and sold, but retained the servicing rights was \$358.9 million. Although these loans are generally sold on a non-recourse basis, except for breaches of customary seller representations and warranties, we may have to repurchase residential mortgage loans in cases where we breach such representations or warranties or the other terms of the sale, such as where we fail to deliver required documents or the documents we deliver are defective. Investors also may require the repurchase of a mortgage loan when an early payment default underwriting review reveals significant underwriting deficiencies, even if the mortgage loan has subsequently been brought current. Repurchase demands are typically reviewed on an individual loan by loan basis to validate the claims made by the investor and to determine if a contractually required repurchase event has occurred. We seek to reduce and manage the risks of potential repurchases or other claims by mortgage loan investors through our underwriting, quality assurance and servicing practices, including good communications with our residential mortgage investors.

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In 2015, as a result of the representation and warranty provisions contained in the Company's sale agreements with Fannie Mae, the Company was required to repurchase two loans with an aggregate principal balance of \$287 thousand that were current as to principal and interest at the time of repurchase and reimburse Fannie Mae approximately \$37 thousand related to a make whole request. The Company repurchased one loan in 2014 with a principal balance of \$387 thousand that was current as to principal and interest at the time of repurchase. At December 31, 2015, the Company had two pending repurchase requests related to representation and warranty provisions.

Also, in January 2015, the Company voluntarily repurchased from Fannie Mae ten investment property loans with an aggregate principal balance of \$4.0 million that were made to the same borrower and were current as to principal and interest. At the date of repurchase, the aggregate fair value of these ten investment property loans was greater than the repurchase price required by Fannie Mae. As part of the Company's quality control review procedures, one of these ten loans was self-reported to Fannie Mae in 2014 for possible breaches related to representation and warranty provisions. After further investigation, the Company identified certain underwriting deficiencies for the other nine investment property loans and submitted the voluntary repurchase request to Fannie Mae. In response to the quality control review findings related to this one borrower, the Company has put additional controls in place for investment property loans originated for sale, including additional quality control reviews and management approvals. Furthermore, management performed additional reviews of investment property loans originated for sale, including a review of the number of loans to one borrower, and does not believe there is any material exposure related to representation and warranty provisions for these loans.

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

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

Although to date repurchase requests related to representation and warranty provisions, and servicing activities have been limited, it is possible that requests to repurchase mortgage loans may increase in frequency if investors more aggressively pursue all means of recovering losses on their purchased loans. As of December 31, 2015, we believe that this exposure is not material due to the historical level of repurchase requests and loss trends, the results of our quality control reviews, and the fact that 99% of our residential mortgage loans serviced for Fannie Mae were current as of such date. We maintain ongoing communications with our investors and will continue to evaluate this exposure by monitoring the level and number of repurchase requests as well as the delinquency rates in our investor portfolios.

## **Effects of Inflation and Changing Prices**

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with GAAP and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of

money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

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**CURRENT ACCOUNTING DEVELOPMENTS**

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

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

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

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

ASU 2015-05, *Customer s Accounting for Fees Paid in a Cloud Computing Arrangement*;

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

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

ASU 2016-02, *Leases*

Information about these pronouncements is described in more detail below.

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

ASU 2015-02, *Amendments to the Consolidation Analysis*, affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. Specifically, the amendments: (1) Modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities ( VIEs ) or voting interest entities; (2) Eliminate the presumption that a general partner should consolidate a limited partnership; (3) Affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships; and (4) Provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are

similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. These changes are effective for the Company in the first quarter of 2016. The adoption of this ASU will not have a material impact on the Company's consolidated financial statements.

ASU No. 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, requires that debt issuance costs related to a recognized debt liability be presented on the balance sheet as a direct deduction from the debt liability, rather than as an asset. These changes are effective for the Company in the first quarter of 2016 with retrospective application to each prior reporting period. The adoption of this ASU will not have a material impact on the consolidated financial statements.

ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*, provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The new guidance does not change the accounting for a customer's accounting for service contracts. These changes are effective for the Company in the first quarter of 2016. The adoption of this ASU will not have a material impact on the consolidated financial statements.

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

ASU 2016-02, *Leases*, requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for lease term. The new guidance is effective for annual and interim reporting periods beginning after December 15, 2018. The amendment should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of the new guidance on its consolidated financial statements.



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

In addition to results presented in accordance with GAAP, this annual report on Form 10-K includes certain designated net interest income amounts presented on a tax-equivalent basis, a non-GAAP financial measure, including the presentation of total revenue and the calculation of the efficiency ratio.

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

	<b>Year ended December 31</b>				
<i>(In thousands)</i>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Net interest income (GAAP)	\$ 22,718	21,453	20,922	20,897	19,225
Tax-equivalent adjustment	1,342	1,288	1,440	1,642	1,719
Net interest income (Tax-equivalent)	\$ 24,060	22,741	22,362	22,539	20,944

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

<i>(Dollars in thousands, except per share amounts)</i>		<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>Year ended December 31</b>	
					<b>2012</b>	<b>2011</b>
<b>Income statement</b>						
Tax-equivalent interest income (a)	\$	28,495	28,105	28,898	30,709	32,425
Total interest expense		4,435	5,364	6,536	8,170	11,481
Tax equivalent net interest income (a)		24,060	22,741	22,362	22,539	20,944
Provision for loan losses		200	50	400	3,815	2,450
Total noninterest income		4,532	3,933	7,298	10,483	5,177
Total noninterest expense		16,372	15,104	18,412	19,383	16,357
Net earnings before income taxes and tax-equivalent adjustment		12,020	11,520	10,848	9,824	7,314
Tax-equivalent adjustment		1,342	1,288	1,440	1,642	1,719
Income tax expense		2,820	2,784	2,290	1,419	57
Net earnings	\$	7,858	7,448	7,118	6,763	5,538
<b>Per share data:</b>						
Basic and diluted net earnings	\$	2.16	2.04	1.95	1.86	1.52
Cash dividends declared	\$	0.88	0.86	0.84	0.82	0.80
Weighted average shares outstanding						
Basic and diluted		3,643,428	3,643,278	3,643,003	3,642,831	3,642,735
Shares outstanding		3,643,478	3,643,328	3,643,118	3,642,903	3,642,738
Book value	\$	21.94	20.80	17.70	19.26	17.96
Common stock price						
High	\$	30.39	25.80	25.75	26.65	20.37
Low		23.15	22.10	20.80	18.23	18.52
Period-end	\$	29.62	23.64	25.00	20.85	18.52
To earnings ratio		13.78x	11.59	12.89	11.21	12.10
To book value		135 %	114	141	108	103
<b>Performance ratios:</b>						
Return on average equity		9.98 %	10.53	10.33	9.85	9.10
Return on average assets		0.98 %	0.97	0.94	0.90	0.72
Dividend payout ratio		40.74 %	42.16	43.08	44.09	52.63
Average equity to average assets		9.79 %	9.17	9.07	9.09	7.89
<b>Asset Quality:</b>						
Allowance for loan losses as a % of:						
Loans		1.01 %	1.20	1.37	1.69	1.87
Nonperforming loans		158 %	433	124	64	67
Nonperforming assets as a % of:						

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Loans and other real estate owned	0.70 %	0.41	2.10	3.83	4.83
Total assets	0.36 %	0.21	1.08	2.03	2.35
Nonperforming loans as % of loans	0.64 %	0.28	1.11	2.65	2.80
Net charge-offs as a % of average loans	0.18 %	0.12	0.48	1.03	0.86
<b>Capital Adequacy:</b>					
CET 1 risk-based capital ratio	15.28 %	na	na	na	na
Tier 1 risk-based capital ratio	16.57 %	17.45	17.19	16.20	15.40
Total risk-based capital ratio	17.44 %	18.54	18.40	17.46	16.66
Tier 1 leverage ratio	10.35 %	10.32	10.10	9.58	8.82
<b>Other financial data:</b>					
Net interest margin (a)	3.17 %	3.15	3.16	3.21	2.95
Effective income tax rate	26.41 %	27.21	24.34	17.34	1.02
Efficiency ratio (b)	57.26 %	56.62	62.08	58.70	62.62
<b>Selected period end balances:</b>					
Securities	\$ 241,687	267,603	271,219	259,475	299,582
Loans, net of unearned income	426,410	402,954	383,339	398,193	370,263
Allowance for loan losses	4,289	4,836	5,268	6,723	6,919
Total assets	817,189	789,231	751,343	759,833	776,218
Total deposits	723,627	693,390	668,844	636,817	619,552
Long-term debt	7,217	12,217	12,217	47,217	85,313
Total stockholders equity	79,949	75,799	64,485	70,149	65,416

- (a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures .
- (b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

**Table of Contents****Table 3 - Average Balance and Net Interest Income Analysis**

<i>(Dollars in thousands)</i>	Year ended December 31					
	Average Balance	2015 Interest Income/Expense	Yield/Rate	Average Balance	2014 Interest Income/Expense	Yield/Rate
<b>Interest-earning assets:</b>						
Loans and loans held for sale (1)	\$ 413,616	\$ 20,484	4.95%	\$ 388,373	\$ 19,551	5.03%
Securities - taxable	186,845	3,851	2.06%	207,655	4,627	2.23%
Securities - tax-exempt (2)	68,386	3,946	5.77%	62,870	3,790	6.03%
Total securities	255,231	7,797	3.05%	270,525	8,417	3.11%
Federal funds sold	58,607	137	0.23%	56,110	109	0.19%
Interest bearing bank deposits	31,028	77	0.25%	6,559	28	0.43%
Total interest-earning assets	758,482	28,495	3.76%	721,567	28,105	3.89%
Cash and due from banks	13,232			12,915		
Other assets	32,413			36,490		
Total assets	\$ 804,127			\$ 770,972		
<b>Interest-bearing liabilities:</b>						
Deposits:						
NOW	\$ 115,146	348	0.30%	\$ 105,533	331	0.31%
Savings and money market	215,936	832	0.39%	191,882	982	0.51%
Certificates of deposits less than \$100,000	91,136	935	1.03%	101,561	1,169	1.15%
Certificates of deposits and other time deposits of \$100,000 or more	140,831	2,020	1.43%	156,029	2,445	1.57%
Total interest-bearing deposits	563,049	4,135	0.73%	555,005	4,927	0.89%

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Short-term borrowings	3,601	18	0.50%	3,814	19	0.50%
Long-term debt	8,286	282	3.40%	12,217	418	3.42%
Total interest-bearing liabilities	574,936	4,435	0.77%	571,036	5,364	0.94%
Noninterest-bearing deposits	147,259			126,122		
Other liabilities	3,208			3,100		
Stockholders equity	78,724			70,714		
Total liabilities and stockholders equity	\$ 804,127			\$ 770,972		

Net interest income and margin	\$ 24,060	3.17%	\$ 22,741	3.15%
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- (1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.
- (2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.

**Table of Contents****Table 4 - Volume and Rate Variance Analysis****Years ended December 31, 2015 vs. 2014 vs. 2013**

	Net	Due to change in		Net	Due to change in	
	Change	Rate (2)	Volume (2)	Change	Rate (2)	Volume (2)
<i>(Dollars in thousands)</i>						
<b>Interest income:</b>						
Loans and loans held for sale	\$ 933	(317)	1,250	\$ (1,053)	(957)	(96)
Securities - taxable	(776)	(347)	(429)	715	452	263
Securities - tax-exempt (1)	156	(162)	318	(444)	(147)	(297)
Total securities	(620)	(509)	(111)	271	305	(34)
Federal funds sold	28	22	6	3	(11)	14
Interest bearing bank deposits	49	(12)	61	(14)	(18)	4
Total interest income	\$ 390	(816)	1,206	\$ (793)	(681)	(112)
<b>Interest expense:</b>						
Deposits:						
NOW	\$ 17	(12)	29	\$ 12	(2)	14
Savings and money market	(150)	(243)	93	96	(9)	105
Certificates of deposits less than \$100,000	(234)	(127)	(107)	(268)	(221)	(47)
Certificates of deposits and other time deposits of \$100,000 or more	(425)	(207)	(218)	(305)	(309)	4
Total interest-bearing deposits	(792)	(589)	(203)	(465)	(541)	76
Short-term borrowings	(1)	0	(1)	5		5
Long-term debt	(136)	(2)	(134)	(712)	(52)	(660)
Total interest expense	(929)	(591)	(338)	(1,172)	(593)	(579)
Net interest income	\$ 1,319	(225)	1,544	\$ 379	(88)	467

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

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

**Table of Contents****Table 5 - Loan Portfolio Composition****December 31**

<i>(In thousands)</i>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Commercial and industrial	\$ 52,479	54,329	57,780	59,334	54,988
Construction and land development	43,694	37,298	36,479	37,631	39,814
Commercial real estate	203,853	192,006	174,920	183,611	162,435
Residential real estate	116,673	107,641	101,706	105,631	101,725
Consumer installment	10,220	12,335	12,893	12,219	11,454
Total loans	426,919	403,609	383,778	398,426	370,416
Less: unearned income	(509)	(655)	(439)	(233)	(153)
Loans, net of unearned income	426,410	402,954	383,339	398,193	370,263
Less: allowance for loan losses	(4,289)	(4,836)	(5,268)	(6,723)	(6,919)
Loans, net	\$ 422,121	398,118	378,071	391,470	363,344

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

		<b>December 31, 2015</b>						
		<b>1 year</b>	<b>1 to 5</b>	<b>After 5</b>		<b>Adjustable</b>	<b>Fixed</b>	
<i>(Dollars in thousands)</i>		<b>or less</b>	<b>years</b>	<b>years</b>	<b>Total</b>	<b>Rate</b>	<b>Rate</b>	<b>Total</b>
Commercial and industrial	\$	63	43,746	8,670	52,479	23,472	29,007	52,479
Construction and land development		848	36,691	6,155	43,694	22,476	21,218	43,694
Commercial real estate		1,506	84,860	117,487	203,853	14,541	189,312	203,853
Residential real estate		1,297	24,921	90,455	116,673	66,474	50,199	116,673
Consumer installment		258	8,826	1,136	10,220	1,721	8,499	10,220
Total loans	\$	3,972	199,044	223,903	426,919	128,684	298,235	426,919



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

	<b>Year ended December 31</b>					
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	
<b>Allowance for loan losses:</b>						
Balance at beginning of period	\$ 4,836	5,268	6,723	6,919	7,676	
<b>Charge-offs:</b>						
Commercial and industrial	(100)	(46)	(514)	(289)	(679)	
Construction and land development		(235)	(39)	(231)	(1,758)	
Commercial real estate	(866)		(262)	(3,184)	(422)	
Residential real estate	(89)	(438)	(808)	(545)	(533)	
Consumer installment	(59)	(89)	(397)	(85)	(21)	
<b>Total charge-offs</b>	<b>(1,114)</b>	<b>(808)</b>	<b>(2,020)</b>	<b>(4,334)</b>	<b>(3,413)</b>	
<b>Recoveries:</b>						
Commercial and industrial	22	71	48	54	34	
Construction and land development	17	8	6	46	2	
Commercial real estate		119	4	71		
Residential real estate	313	112	88	134	155	
Consumer installment	15	16	19	18	15	
<b>Total recoveries</b>	<b>367</b>	<b>326</b>	<b>165</b>	<b>323</b>	<b>206</b>	
<b>Net charge-offs</b>	<b>(747)</b>	<b>(482)</b>	<b>(1,855)</b>	<b>(4,011)</b>	<b>(3,207)</b>	
Provision for loan losses	200	50	400	3,815	2,450	
<b>Ending balance</b>	<b>\$ 4,289</b>	<b>4,836</b>	<b>5,268</b>	<b>6,723</b>	<b>6,919</b>	
as a % of loans	1.01	%	1.20	1.37	1.69	1.87
as a % of nonperforming loans	158	%	433	124	64	67
Net charge-offs as % of average loans	0.18	%	0.12	0.48	1.03	0.86
<b>Nonperforming assets:</b>						
Nonaccrual/nonperforming loans	\$ 2,714	1,117	4,261	10,535	10,354	
Other real estate owned	252	534	3,884	4,919	7,898	
<b>Total nonperforming assets</b>	<b>\$ 2,966</b>	<b>1,651</b>	<b>8,145</b>	<b>15,454</b>	<b>18,252</b>	
as a % of loans and other real estate owned	0.70	%	0.41	2.10	3.83	4.83
as a % total assets	0.36	%	0.21	1.08	2.03	2.35
Nonperforming loans as a % of total loans	0.64	%	0.28	1.11	2.65	2.80
Accruing loans 90 days or more past due	\$		73	58		



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

	December 31										
	2015		2014		2013		2012		2011		
	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*	
(Dollars in thousands)											
Commercial and industrial	\$ 523	12.3	\$ 639	13.5	\$ 386	15.1	\$ 812	14.9	\$ 948	14.9	
Construction and land development	669	10.2	974	9.2	366	9.5	1,545	9.4	1,470	10.2	
Commercial real estate	1,879	47.8	1,928	47.5	3,186	45.5	3,137	46.1	3,009	43.3	
Residential real estate	1,059	27.3	1,119	26.7	1,114	26.5	1,126	26.5	1,363	27.3	
Consumer installment	159	2.4	176	3.1	216	3.4	103	3.1	129	3.1	
Total allowance for loan losses	\$ 4,289		\$ 4,836		\$ 5,268		\$ 6,723		\$ 6,919		

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

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

*(Dollars in thousands)*

	<b>December 31, 2015</b>
<b>Maturity of:</b>	
3 months or less	\$ 9,670
Over 3 months through 6 months	9,501
Over 6 months through 12 months	34,190
Over 12 months	80,810
 Total CDs and other time deposits of \$100,000 or more (1)	 \$ 134,171

(1) includes brokered certificates of deposit.

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**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information called for by ITEM 7A is set forth in ITEM 7 under the caption "Market and Liquidity Risk Management" and is incorporated herein by reference.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

See Financial Statements and Supplementary Data contained within this Annual Report on Form 10-K.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not applicable.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934 (the "Exchange Act"), the Company's management, under the supervision and with the participation of its principal executive and principal financial officer, conducted an evaluation as of the end of the period covered by this report, of the effectiveness of the Company's disclosure controls and procedures as defined in Rule 13a-15(e) under the Exchange Act. Based on that evaluation, and the results of the audit process described below, the Chief Executive Officer and Principal Financial and Accounting Officer concluded that the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in the Company's reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations, and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and the Principal Financial and Accounting Officer, as appropriate, to allow timely decisions regarding disclosure.

**Management's Report on Internal Control Over Financial Reporting**

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation and fair presentation of published financial statements. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Under the direction of the Company's Chief Executive Officer and Chief Financial Officer, management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2015 in accordance with the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control - Integrated Framework (2013). Based on this assessment, management has concluded that such internal control over financial reporting was effective as of December 31, 2015.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the

Company's registered public accounting firm pursuant to the final rules of the Securities and Exchange Commission that permit the Company to provide only a management's report in this annual report.

**Changes in Internal Control Over Financial Reporting**

During the period covered by this report, there has not been any change in the Company's internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None.

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

Auburn National Bancorporation, Inc.

We have audited the accompanying consolidated balance sheets of Auburn National Bancorporation, Inc. and subsidiaries (the Company) as of December 31, 2015 and 2014, and the related consolidated statements of earnings, comprehensive income, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Auburn National Bancorporation, Inc. and subsidiaries as of December 31, 2015 and 2014, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ Elliott Davis Decosimo, LLC

Memphis, Tennessee  
March 10, 2016

**Table of Contents****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Balance Sheets****December 31***(Dollars in thousands, except share data)***2015****2014****Assets:**

Cash and due from banks	\$	9,806	\$	12,856
Federal funds sold		57,395		68,507
Interest bearing bank deposits		46,729		2,140
Cash and cash equivalents		113,930		83,503
Securities available-for-sale		241,687		267,603
Loans held for sale		1,540		1,974
Loans, net of unearned income		426,410		402,954
Allowance for loan losses		(4,289)		(4,836)
Loans, net		422,121		398,118
Premises and equipment, net		11,866		10,807
Bank-owned life insurance		17,433		18,004
Other real estate owned		252		534
Other assets		8,360		8,688
Total assets	\$	817,189	\$	789,231

**Liabilities:****Deposits:**

Noninterest-bearing	\$	156,817	\$	130,160
Interest-bearing		566,810		563,230
Total deposits		723,627		693,390
Federal funds purchased and securities sold under agreements to repurchase		2,951		4,681
Long-term debt		7,217		12,217
Accrued expenses and other liabilities		3,445		3,144
Total liabilities		737,240		713,432

**Stockholders equity:**

Preferred stock of \$.01 par value; authorized 200,000 shares; issued shares  
- none

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Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares		
Additional paid-in capital	3,766	3,763
Retained earnings	80,845	76,193
Accumulated other comprehensive income, net	1,937	2,443
Less treasury stock, at cost - 313,657 shares and 313,807 shares at December 31, 2015 and 2014, respectively	(6,638)	(6,639)
Total stockholders' equity	79,949	75,799
Total liabilities and stockholders' equity	\$ 817,189	\$ 789,231

*See accompanying notes to consolidated financial statements*

**Table of Contents****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Consolidated Statements of Earnings****Year ended December 31***(Dollars in thousands, except share and per share data)*

	<b>2015</b>	<b>2014</b>
<b>Interest income:</b>		
Loans, including fees	\$ 20,484	\$ 19,551
Securities:		
Taxable	3,851	4,627
Tax-exempt	2,604	2,502
Federal funds sold and interest bearing bank deposits	214	137
<b>Total interest income</b>	<b>27,153</b>	<b>26,817</b>
<b>Interest expense:</b>		
Deposits	4,135	4,927
Short-term borrowings	18	19
Long-term debt	282	418
<b>Total interest expense</b>	<b>4,435</b>	<b>5,364</b>
<b>Net interest income</b>	<b>22,718</b>	<b>21,453</b>
<b>Provision for loan losses</b>	<b>200</b>	<b>50</b>
<b>Net interest income after provision for loan losses</b>	<b>22,518</b>	<b>21,403</b>
<b>Noninterest income:</b>		
Service charges on deposit accounts	823	872
Mortgage lending	1,444	1,636
Bank-owned life insurance	747	501
Other	1,502	1,454
Securities gains (losses), net:		
Realized gains (losses), net	16	(197)
Total other-than-temporary impairments		(333)
<b>Total securities gains (losses), net</b>	<b>16</b>	<b>(530)</b>
<b>Total noninterest income</b>	<b>4,532</b>	<b>3,933</b>

**Noninterest expense:**

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Salaries and benefits	9,293	8,943
Net occupancy and equipment	1,547	1,431
Professional fees	756	920
FDIC and other regulatory assessments	472	465
Other real estate owned, net	11	(450)
Prepayment penalties on long-term debt	362	
Other	3,931	3,795
Total noninterest expense	16,372	15,104
<b>Earnings before income taxes</b>	<b>10,678</b>	<b>10,232</b>
<b>Income tax expense</b>	<b>2,820</b>	<b>2,784</b>
<b>Net earnings</b>	<b>\$ 7,858</b>	<b>\$ 7,448</b>
<b>Net earnings per share:</b>		
Basic and diluted	\$ 2.16	\$ 2.04
<b>Weighted average shares outstanding:</b>		
Basic and diluted	3,643,428	3,643,278

*See accompanying notes to consolidated financial statements*

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## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

	Year ended December 31	
<i>(Dollars in thousands)</i>	2015	2014
<b>Net earnings</b>	\$ 7,858	\$ 7,448
<b>Other comprehensive (loss) income, net of tax:</b>		
Unrealized net holding (loss) gain on all other securities	(496)	6,660
Reclassification adjustment for net (gain) loss on securities recognized in net earnings	(10)	335
<b>Other comprehensive (loss) income</b>	(506)	6,995
<b>Comprehensive income</b>	\$ 7,352	\$ 14,443

*See accompanying notes to consolidated financial statements*

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## AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

## Consolidated Statements of Stockholders Equity

	Common Stock		Additional paid-in capital	Retained earnings	Accumulated other comprehensive (loss) income	Treasury stock	Total
	Shares	Amount					
<i>(Dollars in thousands, except share data)</i>							
<b>Balance, December 31, 2013</b>	3,957,135	\$ 39	3,759	71,879	(4,552)	(6,640)	\$ 64,485
Net earnings				7,448			7,448
Other comprehensive income					6,995		6,995
Cash dividends paid (\$0.86 per share)				(3,134)			(3,134)
Sale of treasury stock (210 shares)			4			1	5
<b>Balance, December 31, 2014</b>	3,957,135	\$ 39	\$ 3,763	\$ 76,193	\$ 2,443	\$ (6,639)	\$ 75,799
Net earnings				7,858			7,858
Other comprehensive loss					(506)		(506)
Cash dividends paid (\$0.88 per share)				(3,206)			(3,206)
Sale of treasury stock (150 shares)			3			1	4
<b>Balance, December 31, 2015</b>	3,957,135	\$ 39	\$ 3,766	\$ 80,845	\$ 1,937	\$ (6,638)	\$ 79,949

See accompanying notes to consolidated financial statements



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

	<b>Year ended December 31</b>	
<i>(In thousands)</i>	<b>2015</b>	<b>2014</b>
<b>Cash flows from operating activities:</b>		
Net earnings	\$ 7,858	\$ 7,448
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	200	50
Depreciation and amortization	1,166	780
Premium amortization and discount accretion, net	1,549	1,548
Deferred tax expense	620	786
Net (gain) loss on securities available for sale	(16)	530
Net gain on sale of loans held for sale	(1,152)	(1,163)
Net loss (gain) on other real estate owned	1	(458)
Loss on prepayment of long-term debt	362	
Loans originated for sale	(63,566)	(57,069)
Proceeds from sale of loans	64,623	58,089
Increase in cash surrender value of bank owned life insurance	(471)	(501)
Income recognized from death benefit on bank-owned life insurance	(276)	
Net increase in other assets	(350)	(27)
Net increase in accrued expenses and other liabilities	304	518
Net cash provided by operating activities	\$ 10,852	\$ 10,531
<b>Cash flows from investing activities:</b>		
Proceeds from sales of securities available-for-sale		37,132
Proceeds from maturities of securities available-for-sale	31,334	53,767
Purchase of securities available-for-sale	(7,752)	(78,278)
Increase in loans, net	(24,212)	(20,572)
Net purchases of premises and equipment	(1,534)	(744)
Decrease in FHLB stock	191	235
Proceeds from bank-owned life insurance death benefit	1,319	
Proceeds from sale of other real estate owned	290	4,480
Net cash used in investing activities	\$ (364)	\$ (3,980)
<b>Cash flows from financing activities:</b>		
Net increase in noninterest-bearing deposits	26,657	4,420
Net increase in interest-bearing deposits	3,580	20,126
Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase	(1,730)	1,318
Repayments or retirement of long-term debt	(5,362)	

Dividends paid	(3,206)	(3,134)
Net cash provided by financing activities	\$ 19,939	\$ 22,730
Net change in cash and cash equivalents	\$ 30,427	\$ 29,281
Cash and cash equivalents at beginning of period	83,503	54,222
<b>Cash and cash equivalents at end of period</b>	<b>\$ 113,930</b>	<b>\$ 83,503</b>

**Supplemental disclosures of cash flow information:**

Cash paid during the period for:

Interest	\$ 4,528	\$ 5,406
Income taxes	2,308	1,413

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

Real estate acquired through foreclosure	\$ 9	\$ 475
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*See accompanying notes to consolidated financial statements*



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

**Notes to Consolidated Financial Statements**

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

**Nature of Business**

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

**Basis of Presentation**

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

**Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the balance sheet date and the reported amounts of income and expense during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses, fair value measurements, valuation of other real estate owned, and valuation of deferred tax assets.

**Reclassifications**

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

**Accounting Standards Adopted in 2015**

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*.  
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.

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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 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.

**Cash Equivalents**

Cash equivalents include cash on hand, cash items in process of collection, amounts due from banks, including interest bearing deposits with other banks, and federal funds sold.

**Securities**

Securities are classified based on management's intention at the date of purchase. At December 31, 2015, all of the Company's securities were classified as available-for-sale. Securities available-for-sale are used as part of the Company's interest rate risk management strategy, and they may be sold in response to changes in interest rates,

changes in prepayment risks or other factors. All securities classified as available-for-sale are recorded at fair value with any unrealized gains and losses reported in accumulated other comprehensive income, net of the deferred income tax effects. Interest and dividends on securities, including the amortization of premiums and accretion of discounts are recognized in interest income over the anticipated life of the security using the effective interest method, taking into consideration prepayment assumptions. Realized gains and losses from the sale of securities are determined using the specific identification method.

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

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

## **Loans held for sale**

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Loan sales are recognized when the transaction closes, the proceeds are collected, and ownership is transferred. Continuing involvement, through the sales agreement, consists of the right to service the loan for a fee for the life of the loan, if applicable. Gains on the sale of loans held for sale are recorded net of related costs, such as commissions, and reflected as a component of mortgage lending income in the consolidated statements of earnings.

In the course of conducting the Bank's mortgage lending activities of originating mortgage loans and selling those loans in the secondary market, the Bank makes various representations and warranties to the purchaser of the mortgage loans. Every loan closed by the Bank's mortgage center is run through a government agency automated underwriting system. Any exceptions noted during this process are remedied prior to sale. These representations and warranties also apply to underwriting the real estate appraisal opinion of value for the collateral securing these loans. Failure by the Company to comply with the underwriting and/or appraisal standards could result in the Company being required to repurchase the mortgage loan or to reimburse the investor for losses incurred (make whole requests) if such failure cannot be cured by the Company within the specified period following discovery.

## **Loans**

Loans are reported at their outstanding principal balances, net of any unearned income, charge-offs, and any deferred fees or costs on originated loans. Interest income is accrued based on the principal balance outstanding. Loan origination fees, net of certain loan origination costs, are deferred and recognized in interest income over the contractual life of the loan using the effective interest method. Loan commitment fees are generally deferred and amortized on a straight-line basis over the commitment period, which results in a recorded amount that approximates fair value.

The accrual of interest on loans is discontinued when there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or the principal or interest is more than 90 days past due, unless the loan is both well-collateralized and in the process of collection. Generally, all interest accrued but not collected for loans that are placed on nonaccrual status is reversed against current interest income. Interest collections on nonaccrual loans are generally applied as principal reductions. The Company determines past due or delinquency status of a loan based on contractual payment terms.

A loan is considered impaired when it is probable the Company will be unable to collect all principal and interest payments due according to the contractual terms of the loan agreement. Individually identified impaired loans are measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. If the recorded investment in the impaired loan exceeds the measure of fair value, a valuation allowance may be established as part of the allowance for loan losses. Changes to the valuation allowance are recorded as a component of the provision for loan losses.

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Impaired loans also include troubled debt restructurings ( TDRs ). In the normal course of business, management may grant concessions to borrowers who are experiencing financial difficulty. The concessions granted most frequently for TDRs involve reductions or delays in required payments of principal and interest for a specified time, the rescheduling of payments in accordance with a bankruptcy plan or the charge-off of a portion of the loan. In most cases, the conditions of the credit also warrant nonaccrual status, even after the restructuring occurs. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructuring. TDR loans may be returned to accrual status if there has been at least a six-month sustained period of repayment performance by the borrower.

## **Allowance for Loan Losses**

The allowance for loan losses is maintained at a level that management believes is adequate to absorb probable losses inherent in the loan portfolio. Loan losses are charged against the allowance when they are known. Subsequent recoveries are credited to the allowance. Management's determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, growth, composition of the loan portfolio, homogeneous pools of loans, risk ratings of specific loans, historical loan loss factors, identified impaired loans and other factors related to the portfolio. This evaluation is performed quarterly and is inherently subjective, as it requires various material estimates that are susceptible to significant change, including the amounts and timing of future cash flows expected to be received on any impaired loans. In addition, regulatory agencies, as an integral part of their examination process, will periodically review the Company's allowance for loan losses, and may require the Company to record additions to the allowance based on their judgment about information available to them at the time of their examinations.

## **Premises and Equipment**

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation computed on a straight-line method over the useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured.

## **Other Real Estate Owned**

Other real estate owned ( OREO ) includes properties acquired through, or in lieu of, loan foreclosure that are held for sale and are initially recorded at the lower of the loan's carrying amount or fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying value amount or fair value less cost to sell. Gains or losses realized upon sale of OREO and additional losses related to subsequent valuation adjustments are determined on a specific property basis and are included as a component of noninterest expense along with holding costs.

## **Nonmarketable equity investments**

Nonmarketable equity investments include equity securities that are not publicly traded and securities acquired for various purposes. The Bank is required to maintain certain minimum levels of equity investments with certain regulatory and other entities in which the Bank has an ongoing business relationship based on the Bank's common stock and surplus (with regard to the relationship with the Federal Reserve Bank) or outstanding borrowings (with regard to the relationship with the Federal Home Loan Bank of Atlanta). These securities are accounted for under the cost method and are included in other assets. For cost-method investments, on a quarterly basis, 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. If the Company determines that a decline in value is

other-than-temporary, the Company will recognize the estimated loss in securities gains (losses), net.

**Transfers of Financial Assets**

Transfers of an entire financial asset (i.e. loan sales), a group of entire financial assets, or a participating interest in an entire financial asset (i.e. loan participations sold) are accounted for as sales when control over the assets have been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.



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### **Mortgage Servicing Rights**

The Company recognizes as assets the rights to service mortgage loans for others, known as MSR. The Company determines the fair value of MSR at the date the loan is transferred. An estimate of the Company's MSR is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees.

Subsequent to the date of transfer, the Company has elected to measure its MSR under the amortization method. Under the amortization method, MSR are amortized in proportion to, and over the period of, estimated net servicing income. The amortization of MSR is analyzed monthly and is adjusted to reflect changes in prepayment speeds, as well as other factors. MSR are evaluated for impairment based on the fair value of those assets. Impairment is determined by stratifying MSR into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSR exceeds fair value, a valuation allowance is established through a charge to earnings. The valuation allowance is adjusted as the fair value changes. MSR are included in the other assets category in the accompanying consolidated balance sheets.

### **Derivative Instruments**

In accordance with Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*, all derivative instruments are recorded on the consolidated balance sheet at their respective fair values.

The accounting for changes in fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. If the derivative instrument is not designated as part of a hedging relationship, the gain or loss on the derivative instrument is recognized in earnings in the period of change. None of the derivatives utilized by the Company have been designated as a hedge.

### **Securities sold under agreements to repurchase**

Securities sold under agreements to repurchase generally mature less than one year from the transaction date. Securities sold under agreements to repurchase are reflected as a secured borrowing in the accompanying consolidated balance sheets at the amount of cash received in connection with each transaction.

### **Income Taxes**

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. The net deferred tax asset is reflected as a component of other assets in the accompanying consolidated balance sheets.

Income tax expense or benefit for the year is allocated among continuing operations and other comprehensive income (loss), as applicable. The amount allocated to continuing operations is the income tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (1) changes in certain circumstances that cause a change in judgment about the realization of deferred tax assets in future years, (2) changes in income tax laws or rates, and (3) changes in income tax status, subject to certain exceptions. The amount allocated to other comprehensive income (loss) is related solely to changes in the valuation allowance on items that are normally accounted for in other comprehensive income (loss) such as unrealized gains or losses on

available-for-sale securities.

In accordance with ASC 740, *Income Taxes*, a tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded. It is the Company's policy to recognize interest and penalties related to income tax matters in income tax expense. The Company and its wholly-owned subsidiaries file a consolidated income tax return.

**Table of Contents****Fair Value Measurements**

ASC 820, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. ASC 820 applies only to fair-value measurements that are already required or permitted by other accounting standards. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. For more information related to fair value measurements, please refer to Note 17, Fair Value.

**Subsequent Events**

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to December 31, 2015. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

**NOTE 2: BASIC AND DILUTED NET EARNINGS PER SHARE**

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the year. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company's common stock. As of December 31, 2015 and 2014, respectively, the Company had no such securities or other rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted net earnings per share calculation.

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

	<b>Year ended December 31</b>	
<i>(Dollars in thousands, except share and per share data)</i>	<b>2015</b>	<b>2014</b>
<b>Basic and diluted:</b>		
Net earnings	\$ 7,858	\$ 7,448
Weighted average common shares outstanding	3,643,428	3,643,278
Net earnings per share	\$ 2.16	\$ 2.04

**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 December 31, 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.

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The following table summarizes VIEs that are not consolidated by the Company as of December 31, 2015.

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

**NOTE 4: RESTRICTED CASH BALANCES**

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. As of December 31, 2015 and 2014, the Bank did not have a required reserve balance at the Federal Reserve Bank.

**NOTE 5: SECURITIES**

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

	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized		Amortized Cost
(Dollars in thousands)						Gains	Losses	
<b>December 31, 2015</b>								
Agency obligations (a)	\$ 5,000	25,852	19,463	9,770	60,085	384	518	\$ 60,219
Agency RMBS (a)		1,623	13,511	95,820	110,954	968	780	110,766
State and political subdivisions		497	12,094	58,057	70,648	3,022	7	67,633
<b>Total available-for-sale</b>	<b>\$ 5,000</b>	<b>27,972</b>	<b>45,068</b>	<b>163,647</b>	<b>241,687</b>	<b>4,374</b>	<b>1,305</b>	<b>\$ 238,618</b>

**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 \$133.3 million and \$132.2 million at December 31, 2015 and 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 on the accompanying consolidated balance sheets are cost-method investments. The carrying amounts of cost-method investments were \$1.4 and \$1.6 million at December 31, 2015 and 2014, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank ( FRB ) stock.

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

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

	Less than 12 Months		12 Months or Longer		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
<i>(Dollars in thousands)</i>	Value	Losses	Value	Losses	Value	Losses
<b>December 31, 2015:</b>						
Agency obligations	\$ 8,157	2	24,444	516	32,601	\$ 518
Agency RMBS	42,345	367	18,184	413	60,529	780
State and political subdivisions	267	1	969	6	1,236	7
<b>Total</b>	<b>\$ 50,769</b>	<b>370</b>	<b>43,597</b>	<b>935</b>	<b>94,366</b>	<b>\$ 1,305</b>
<b>December 31, 2014:</b>						
Agency obligations	\$ 24,126	830	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
<b>Total</b>	<b>\$ 13,335</b>	<b>56</b>	<b>66,870</b>	<b>1,424</b>	<b>80,205</b>	<b>\$ 1,480</b>

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

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

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

adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security,

in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);

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

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

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

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

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

*Agency obligations*

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

*Agency residential mortgage-backed securities ( RMBS )*

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



**Table of Contents***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 December 31, 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 significant other-than-temporary impairment charges may occur in the future.

**Other-Than-Temporarily Impaired Securities**

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

**Other-Than-Temporary Impairment**

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

	<b>Year ended December 31</b>	
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
<b>Other-than-temporary impairment charges (included in earnings):</b>		
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 and other-than-temporary impairment charges related to securities.

<i>(Dollars in thousands)</i>	Year ended December 31	
	2015	2014
Gross realized gains	\$ 16	467
Gross realized losses		(664)
Realized gains (losses), net	\$ 16	(197)

**Table of Contents****NOTE 6: LOANS AND ALLOWANCE FOR LOAN LOSSES**

	<b>December 31</b>	
<i>(In thousands)</i>	<b>2015</b>	<b>2014</b>
Commercial and industrial	\$ 52,479	\$ 54,329
Construction and land development	43,694	37,298
Commercial real estate:		
Owner occupied	46,602	52,296
Other	157,251	139,710
Total commercial real estate	203,853	192,006
Residential real estate:		
Consumer mortgage	70,009	66,489
Investment property	46,664	41,152
Total residential real estate	116,673	107,641
Consumer installment	10,220	12,335
Total loans	426,919	403,609
Less: unearned income	(509)	(655)
Loans, net of unearned income	\$ 426,410	\$ 402,954

Loans secured by real estate were approximately 85.3% of the total loan portfolio at December 31, 2015. At December 31, 2015, the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

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

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

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

*Construction and land development ( C&D )* includes both loans and credit lines for the purpose of purchasing, carrying and developing land into commercial developments or residential subdivisions. Also included are loans and

lines for construction of residential, multi-family and commercial buildings. Generally the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

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

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

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

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

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

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

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

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

(In thousands)	Accruing		Accruing		Total	
	Current	Past Due	30-89 Days	Greater than	Accruing	Non-Accrual
			Loans	90 days		
<b>December 31, 2015:</b>						
Commercial and industrial	\$ 52,387	49			52,436	43
Construction and land development	43,111				43,111	583
Commercial real estate:						
Owner occupied	46,372				46,372	230
Other	155,731				155,731	1,520
Total commercial real estate	202,103				202,103	1,750
Residential real estate:						
Consumer mortgage	68,579	1,105			69,684	325
Investment property	46,435	229			46,664	

Total residential real estate	115,014	1,334	116,348	325	116,673
Consumer installment	10,179	28	10,207	13	10,220
<b>Total</b>	<b>\$ 422,794</b>	<b>1,411</b>	<b>424,205</b>	<b>2,714</b>	<b>\$ 426,919</b>

**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
<b>Total commercial real estate</b>	<b>191,542</b>	<b>201</b>	<b>191,743</b>	<b>263</b>	<b>192,006</b>
Residential real estate:					
Consumer mortgage	64,713	1,736	66,449	40	66,489
Investment property	40,503	495	40,998	154	41,152
<b>Total residential real estate</b>	<b>105,216</b>	<b>2,231</b>	<b>107,447</b>	<b>194</b>	<b>107,641</b>
Consumer installment	12,290	45	12,335		12,335
<b>Total</b>	<b>\$ 399,637</b>	<b>2,855</b>	<b>402,492</b>	<b>1,117</b>	<b>\$ 403,609</b>

The gross interest income which would have been recorded under the original terms of those nonaccrual loans had they been accruing interest, amounted to approximately \$133 thousand and \$102 thousand for the years ended December 31, 2015 and 2014, respectively.

**Table of Contents****Allowance for Loan Losses**

The allowance for loan losses as of and for the years ended December 31, 2015 and 2014, is presented below.

<i>(In thousands)</i>	<b>Year ended December 31</b>	
	<b>2015</b>	<b>2014</b>
Beginning balance	\$ 4,836	\$ 5,268
Charged-off loans	(1,114)	(808)
Recovery of previously charged-off loans	367	326
Net charge-offs	(747)	(482)
Provision for loan losses	200	50
Ending balance	\$ 4,289	\$ 4,836

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

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

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

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

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal, independent loan review process. The Company's loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company's loan review process includes the judgment of management, the input from our independent

loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

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

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



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

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 began calculating average losses for all loan segments using a rolling 20 quarter historical period and continued this methodology through December 31, 2015. Prior to June 30, 2014 the Company calculated average losses for all loan segments using a rolling 8 quarter historical period (except for commercial real estate loan segment which used a 6 quarter historic 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 years ended December 31, 2015 and 2014.

<i>(in thousands)</i>	<b>Commercial and industrial</b>	<b>Construction and land Development</b>	<b>Commercial Real Estate</b>	<b>Residential Real Estate</b>	<b>Consumer Installment</b>	<b>Total</b>
<b>Balance, December 31, 2013</b>	\$ 386	366	3,186	1,114	216	\$ 5,268
Charge-offs	(46)	(235)		(438)	(89)	(808)
Recoveries	71	8	119	112	16	326
Net recoveries (charge-offs)	25	(227)	119	(326)	(73)	(482)
Provision	228	835	(1,377)	331	33	50
<b>Balance, December 31, 2014</b>	\$ 639	974	1,928	1,119	176	\$ 4,836
Charge-offs	(100)		(866)	(89)	(59)	(1,114)
Recoveries	22	17		313	15	367
Net (charge-offs) recoveries	(78)	17	(866)	224	(44)	(747)
Provision	(38)	(322)	817	(284)	27	200

<b>Balance, December 31, 2015</b>	\$	523	669	1,879	1,059	159	\$	4,289
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The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of December 31, 2015 and 2014.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
	Allowance	Recorded	Allowance	Recorded	Allowance	Recorded
	for loan	investment	for	investment	for	investment
	losses	in loans	losses	in loans	losses	in loans
<i>(In thousands)</i>						
<b>December 31, 2015:</b>						
Commercial and industrial	\$	523	52,431	48	523	52,479
Construction and land development		669	43,111	583	669	43,694
Commercial real estate		1,758	201,077	121	2,776	203,853
Residential real estate		1,059	116,673		1,059	116,673
Consumer installment		159	10,220		159	10,220
<b>Total</b>	<b>\$</b>	<b>4,168</b>	<b>423,512</b>	<b>121</b>	<b>3,407</b>	<b>426,919</b>
<b>December 31, 2014:</b>						
Commercial and industrial	\$	639	54,259	70	639	54,329
Construction and land development		974	36,693	605	974	37,298
Commercial real estate		1,734	190,306	194	1,700	192,006
Residential real estate		1,119	106,745	896	1,119	107,641
Consumer installment		176	12,335		176	12,335
<b>Total</b>	<b>\$</b>	<b>4,642</b>	<b>400,338</b>	<b>194</b>	<b>3,271</b>	<b>403,609</b>

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

**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 in doubt.

<i>(In thousands)</i>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard Accruing</b>	<b>Nonaccrual</b>	<b>Total loans</b>
<b>December 31, 2015</b>					
Commercial and industrial	\$ 48,038	4,075	323	43	\$ 52,479
Construction and land development	42,458	60	593	583	43,694
Commercial real estate:					
Owner occupied	45,772	381	219	230	46,602
Other	155,423	36	272	1,520	157,251
<b>Total commercial real estate</b>	<b>201,195</b>	<b>417</b>	<b>491</b>	<b>1,750</b>	<b>203,853</b>
Residential real estate:					
Consumer mortgage	64,502	1,964	3,218	325	70,009
Investment property	45,399	112	1,153		46,664
<b>Total residential real estate</b>	<b>109,901</b>	<b>2,076</b>	<b>4,371</b>	<b>325</b>	<b>116,673</b>
Consumer installment	10,038	55	114	13	10,220
<b>Total</b>	<b>\$ 411,630</b>	<b>6,683</b>	<b>5,892</b>	<b>2,714</b>	<b>\$ 426,919</b>

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

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

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

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

<i>(In thousands)</i>	<b>December 31, 2015</b>			<b>Related allowance</b>
	<b>Unpaid principal balance (1)</b>	<b>Charge-offs and payments applied (2)</b>	<b>Recorded investment (3)</b>	
<b>With no allowance recorded:</b>				
Commercial and industrial	\$ 48		48	
Construction and land development	2,582	(1,999)	583	
Commercial real estate:				
Owner occupied	308	(78)	230	
Other	2,136	(617)	1,519	
<b>Total commercial real estate</b>	<b>2,444</b>	<b>(695)</b>	<b>1,749</b>	
<b>Total</b>	<b>\$ 5,074</b>	<b>(2,694)</b>	<b>2,380</b>	
<b>With allowance recorded:</b>				
Commercial real estate:				
Owner occupied	1,027		1,027	121
<b>Total commercial real estate</b>	<b>1,027</b>		<b>1,027</b>	<b>121</b>
<b>Total</b>	<b>\$ 1,027</b>		<b>1,027</b>	<b>\$ 121</b>
<b>Total impaired loans</b>	<b>\$ 6,101</b>	<b>(2,694)</b>	<b>3,407</b>	<b>\$ 121</b>

- (1) Unpaid principal balance represents the contractual obligation due from the customer.
- (2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.
- (3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

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	<b>December 31, 2014</b>			
	<b>Unpaid</b>	<b>Charge-offs</b>		
<i>(In thousands)</i>	<b>principal</b>	<b>and payments</b>	<b>Recorded</b>	<b>Related</b>
	<b>balance (1)</b>	<b>applied</b>	<b>investment (3)</b>	<b>allowance</b>
	<b>(2)</b>			
<b>With no allowance recorded:</b>				
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	
<b>Total</b>	<b>\$ 4,337</b>	<b>(2,503)</b>	<b>1,834</b>	
<b>With allowance recorded:</b>				
Commercial real estate:				
Owner occupied	\$ 846		846	\$ 102
Other	591		591	92
Total commercial real estate	1,437		1,437	194
<b>Total</b>	<b>\$ 1,437</b>		<b>1,437</b>	<b>\$ 194</b>
<b>Total impaired loans</b>	<b>\$ 5,774</b>	<b>(2,503)</b>	<b>3,271</b>	<b>\$ 194</b>

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

(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.

(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.

**Year ended December 31, 2015**

**Year ended December 31, 2014**



	<b>Average</b>	<b>Total interest</b>	<b>Average</b>	<b>Total interest</b>
	<b>recorded</b>	<b>income</b>	<b>recorded</b>	<b>income</b>
<i>(In thousands)</i>	<b>investment</b>	<b>recognized</b>	<b>investment</b>	<b>recognized</b>
<b>Impaired loans:</b>				
Commercial and industrial	\$ 60	4	\$ 98	7
Construction and land development	603		1,032	
Commercial real estate:				
Owner occupied	1,328	62	1,308	40
Other	911	18	872	29
Total commercial real estate	2,239	80	2,180	69
Residential real estate:				
Consumer mortgages	349	173	731	43
Investment property	70	76	164	
Total residential real estate	419	249	895	43
Total	\$ 3,321	333	\$ 4,205	119

Interest income recognized for 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 2015 would have been \$108 thousand.

**Table of Contents****Troubled Debt Restructurings**

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

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

The following is a summary of accruing and nonaccrual TDRs and the related loan losses, by portfolio segment and class.

<i>(In thousands)</i>	<b>TDRs</b>			<b>Related</b>
	<b>Accruing</b>	<b>Nonaccrual</b>	<b>Total</b>	<b>Allowance</b>
<b>December 31, 2015</b>				
Commercial and industrial	\$ 48		48	\$
Construction and land development		582	582	
Commercial real estate:				
Owner occupied	1,027	230	1,257	121
Total commercial real estate	1,027	230	1,257	121
<b>Total</b>	<b>\$ 1,075</b>	<b>812</b>	<b>1,887</b>	<b>\$ 121</b>
<b>December 31, 2014</b>				
Commercial and industrial	\$ 70		70	\$
Construction and land development		605	605	
Commercial real estate:				
Owner occupied	846	263	1,109	102

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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 December 31, 2015, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

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

<i>(\$ in thousands)</i>	<b>Number of contracts</b>	<b>Pre- modification outstanding recorded investment</b>	<b>Post- modification outstanding recorded investment</b>
<b>December 31, 2015</b>			
Commercial and industrial	1	\$ 61	66
Construction and land development	1	116	113
Commercial real estate:			
Owner occupied	1	216	218
Other	1	592	592
Total commercial real estate	2	808	810
Total	4	\$ 985	989
<b>December 31, 2014</b>			
Commercial real estate:			
Other	1	\$ 590	592
Total commercial real estate	1	590	592
Residential real estate:			
Consumer mortgages	1	712	712
Total residential real estate	1	712	712
Total	2	\$ 1,302	1,304

The majority of the loans modified in a TDR during the years ended December 31, 2015 and 2014, respectively, included delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was not considered to be a market rate.

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

*(\$ in thousands)*

	<b>Number of Contracts</b>	<b>Recorded investment (1)</b>
<b>December 31, 2015</b>		
Commercial real estate:		
Owner occupied	1	\$ 262
Total commercial real estate	1	262
Residential real estate:		
Investment property	1	150
Total residential real estate	1	150
Total	2	\$ 412
<b>December 31, 2014</b>		
Commercial real estate:		
Owner occupied	1	\$ 272
Total commercial real estate	1	272
Total	1	\$ 272

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

**Table of Contents****NOTE 7: PREMISES AND EQUIPMENT**

Premises and equipment at December 31, 2015 and 2014 is presented below.

		<b>December 31</b>	
<i>(Dollars in thousands)</i>		<b>2015</b>	<b>2014</b>
Land	\$	6,106	5,916
Buildings and improvements		9,448	8,606
Furniture, fixtures, and equipment		3,159	3,214
Total premises and equipment		18,713	17,736
Less: accumulated depreciation		(6,847)	(6,929)
Premises and equipment, net	\$	11,866	10,807

Depreciation expense was approximately \$475 thousand and \$380 thousand for the years ended December 31, 2015 and 2014, respectively, and is a component of net occupancy and equipment expense in the consolidated statements of earnings.

**NOTE 8: MORTGAGE SERVICING RIGHTS, NET**

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

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

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

The following table details the changes in amortized MSRs and the related valuation allowance for the years ended December 31, 2015 and 2014.

	<b>Year ended December 31</b>	
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
Beginning balance	\$ 2,388	2,350
Additions, net	529	465
Amortization expense	(654)	(374)
Change in valuation allowance	53	(53)
Ending balance	\$ 2,316	2,388

**Valuation allowance included in MSRs, net:**

Beginning of period	\$ 53	
End of period		53

**Fair value of amortized MSRs:**

Beginning of period	\$ 3,238	3,452
End of period	3,086	3,238

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Data and assumptions used in the fair value calculation related to MSR's at December 31, 2015 and 2014, respectively, are presented below.

	<b>December 31</b>	
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
Unpaid principal balance	\$ 358,928	360,956
Weighted average prepayment speed (CPR)	10.0 %	9.6
Discount rate (annual percentage)	10.0 %	10.0
Weighted average coupon interest rate	3.9 %	3.9
Weighted average remaining maturity (months)	266	267
Weighted average servicing fee (basis points)	25.0	25.0

At December 31, 2015, the weighted average amortization period for MSR's was 6.1 years. Estimated amortization expense for each of the next five years is presented below.

<i>(Dollars in thousands)</i>	<b>December 31, 2015</b>	
2016	\$	348
2017		298
2018		256
2019		216
2020		187

**NOTE 9: DEPOSITS**

At December 31, 2015, the scheduled maturities of certificates of deposit and other time deposits are presented below.

<i>(Dollars in thousands)</i>	<b>December 31, 2015</b>	
2016	\$	95,611
2017		56,854
2018		24,366
2019		33,027
2020		9,567
Thereafter		173
<b>Total certificates of deposit and other time deposits</b>	<b>\$</b>	<b>219,598</b>

Additionally, at December 31, 2015 and 2014, approximately \$59.6 million and \$62.4 million, respectively, of certificates of deposit and other time deposits were issued in denominations of \$250 thousand or greater.



At December 31, 2015 and 2014, the amount of deposit accounts in overdraft status that were reclassified to loans on the accompanying consolidated balance sheets was not material.

**Table of Contents****NOTE 10: SHORT-TERM BORROWINGS**

At December 31, 2015 and 2014, the composition of short-term borrowings is presented below.

<i>(Dollars in thousands)</i>	2015		2014			
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate		
<b>Federal funds purchased:</b>						
As of December 31	\$		\$			
Average during the year	16	0.90 %	16	0.90 %		
Maximum outstanding at any month-end						
<b>Securities sold under agreements to repurchase:</b>						
As of December 31	\$	2,951	0.50 %	\$	4,681	0.50 %
Average during the year		3,585	0.50 %		3,797	0.50 %
Maximum outstanding at any month-end		4,806			4,681	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling \$41.0 million with none outstanding at December 31, 2015.

Securities sold under agreements to repurchase represent short-term borrowings with maturities less than one year collateralized by a portion of the Company's securities portfolio. Securities with an aggregate carrying value of \$6.3 million and \$6.7 million at December 31, 2015 and 2014, respectively, were pledged to secure securities sold under agreements to repurchase.

**NOTE 11: LONG-TERM DEBT**

At December 31, 2015 and 2014, the composition of long-term debt is presented below.

<i>(Dollars in thousands)</i>	2015		2014		
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate	
FHLB advances, due 2018	\$		\$	5,000	3.59%
Subordinated debentures, due 2033		7,217		7,217	3.38
Total long-term debt	\$	7,217	\$	12,217	3.47%

The Bank had no FHLB advances with original maturities greater than one year at December 31, 2015 and \$5.0 million at December 31, 2014. Certain qualifying residential mortgage loans with an aggregate carrying value of \$31.9 million and \$35.4 million at December 31, 2015 and 2014, respectively, were pledged to secure long-term FHLB advances.

The Company formed Auburn National Bancorporation Capital Trust I, a wholly-owned statutory business trust, in 2003. The Trust issued \$7.0 million of trust preferred securities that were sold to third parties. The proceeds from the sale of the trust preferred securities and trust common securities that we hold, were used to purchase subordinated debentures of \$7.2 million from the Company, which are presented as long-term debt in the consolidated balance sheets and qualify for inclusion in Tier 1 capital for regulatory capital purposes, subject to certain limitations. The debentures mature on December 31, 2033 and have been redeemable since December 31, 2008.

The following is a schedule of contractual maturities of long-term debt:

<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>Thereafter</b>	<b>Total</b>
Subordinated debentures						7,217	7,217
Total long-term debt	\$					7,217	7,217

**Table of Contents****NOTE 12: OTHER COMPREHENSIVE INCOME (LOSS)**

Comprehensive income is defined as the change in equity from all transactions other than those with stockholders, and it includes net earnings and other comprehensive income (loss). Other comprehensive income (loss) for the years ended December 31, 2015 and 2014, is presented below.

<i>(In thousands)</i>	<b>Pre-tax amount</b>	<b>Tax benefit (expense)</b>	<b>Net of tax amount</b>
<b>2015:</b>			
Unrealized net holding loss on all other securities	\$ (785)	289	(496)
Reclassification adjustment for net gain on securities recognized in net earnings	(16)	6	(10)
Other comprehensive loss	\$ (801)	295	(506)
<b>2014:</b>			
Unrealized net holding gain on all other securities	\$ 10,553	(3,893)	6,660
Reclassification adjustment for net loss on securities recognized in net earnings	530	(195)	335
Other comprehensive income	\$ 11,083	(4,088)	6,995

**Table of Contents****NOTE 13: INCOME TAXES**

For the years ended December 31, 2015 and 2014 the components of income tax expense from continuing operations are presented below.

	<b>Year ended December 31</b>	
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
<b>Current income tax expense:</b>		
Federal	\$ 1,805	1,601
State	395	397
<b>Total current income tax expense</b>	<b>2,200</b>	<b>1,998</b>
<b>Deferred income tax expense:</b>		
Federal	586	731
State	34	55
<b>Total deferred income tax expense</b>	<b>620</b>	<b>786</b>
<b>Total income tax expense</b>	<b>\$ 2,820</b>	<b>2,784</b>

Total income tax expense differs from the amounts computed by applying the statutory federal income tax rate of 34% to earnings before income taxes. A reconciliation of the differences for the years ended December 31, 2015 and 2014, is presented below.

<i>(Dollars in thousands)</i>	<b>2015</b>		<b>2014</b>	
	<b>Amount</b>	<b>Percent of pre-tax earnings</b>	<b>Amount</b>	<b>Percent of pre-tax earnings</b>
Earnings before income taxes	\$ 10,678		10,232	
Income taxes at statutory rate	3,631	34.0 %	3,479	34.0 %
Tax-exempt interest	(873)	(8.1)	(803)	(7.8)
State income taxes, net of federal tax effect	280	2.6	295	2.9
Bank-owned life insurance	(254)	(2.4)	(170)	(1.7)
Other	36	0.3	(17)	(0.2)

Total income tax expense	\$	2,820	26.4 %	2,784	27.2 %
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The Company had net deferred tax assets of \$0.2 million and \$0.5 million at December 31, 2015 and 2014, respectively, included in other assets on the consolidated balance sheets. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2015 and 2014 are presented below:

		<b>December 31</b>	
<i>(Dollars in thousands)</i>		<b>2015</b>	<b>2014</b>
<b>Deferred tax assets:</b>			
Allowance for loan losses	\$	1,583	1,784
Write-downs on other real estate owned		20	20
Tax credit carry-forwards		484	816
Other		519	480
<b>Total deferred tax assets</b>		<b>2,606</b>	<b>3,100</b>
<b>Deferred tax liabilities:</b>			
Premises and equipment		219	69
Unrealized gain on securities		1,132	1,427
Originated mortgage servicing rights		855	881
Other		205	204
<b>Total deferred tax liabilities</b>		<b>2,411</b>	<b>2,581</b>
<b>Net deferred tax asset</b>	<b>\$</b>	<b>195</b>	<b>519</b>

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A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion of the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projection for future taxable income over the periods which the temporary differences resulting in the remaining deferred tax assets are deductible, management believes it is more-likely-than-not that the Company will realize the benefits of these deductible differences at December 31, 2015. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

The change in the net deferred tax asset for the years ended December 31, 2015 and 2014, is presented below.

	<b>Year ended December 31</b>	
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
<b>Net deferred tax asset:</b>		
Balance, beginning of year	\$ 519	5,393
Deferred tax expense related to continuing operations	(620)	(786)
Stockholders' equity, for accumulated other comprehensive loss (income)	296	(4,088)
Balance, end of year	\$ 195	519

ASC 740, *Income Taxes*, defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. This section also provides guidance on the de-recognition, measurement, and classification of income tax uncertainties in interim periods. As of December 31, 2015, the Company had no unrecognized tax benefits related to federal or state income tax matters. The Company does not anticipate any material increase or decrease in unrecognized tax benefits during 2016 relative to any tax positions taken prior to December 31, 2015. As of December 31, 2015, the Company has accrued no interest and no penalties related to uncertain tax positions. It is the Company's policy to recognize interest and penalties related to income tax matters in income tax expense.

The Company and its subsidiaries file consolidated U.S. federal and State of Alabama income tax returns. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service and the State of Alabama for the years ended December 31, 2012 through 2015.

**NOTE 14: EMPLOYEE BENEFIT PLAN**

The Company has a 401(k) Plan that covers substantially all employees. Participants may contribute up to 10% of eligible compensation subject to certain limits based on federal tax laws. The Company's matching contributions to the Plan are determined by the board of directors. Participants become 20% vested in their accounts after two years of service and 100% vested after six years of service. Company matching contributions to the Plan were \$116 thousand and \$122 thousand for the years ended December 31, 2015 and 2014, respectively, and are included in salaries and benefits expense.

**NOTE 15: 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. At December 31, 2015 and December 31, 2014, the Company had no derivative contracts to assist in managing its own interest rate sensitivity.

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



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A summary of the Company's interest rate swaps as of and for the years ended December 31, 2015 and 2014 is presented below.

		Other Assets	Other Liabilities	Other noninterest <u>income</u>
		Estimated	Estimated	Gains (Losses)
<i>(Dollars in thousands)</i>	Notional	Fair Value	Fair Value	
<b>December 31, 2015:</b>				
Pay fixed / receive variable	\$ 4,317		440	\$ 194
Pay variable / receive fixed	4,317	440		(194)
Total interest rate swap agreements	\$ 8,634	440	440	\$
<b>December 31, 2014:</b>				
Pay fixed / receive variable	\$ 4,667		634	\$ 210
Pay variable / receive fixed	4,667	634		(210)
Total interest rate swap agreements	\$ 9,334	634	634	\$

**NOTE 16: COMMITMENTS AND CONTINGENT LIABILITIES*****Credit-Related Financial Instruments***

The Company is party to credit related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

At December 31, 2015 and 2014, the following financial instruments were outstanding whose contract amount represents credit risk:

December 31

<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
Commitments to extend credit	\$ 52,230	\$ 49,824
Standby letters of credit	8,221	8,337

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds various assets as collateral, including accounts receivable, inventory, equipment, marketable securities, and property to support those commitments for which collateral is deemed necessary. The Company has recorded a liability for the estimated fair value of these standby letters of credit in the amount of \$69 thousand and \$72 thousand at December 31, 2015 and 2014, respectively.

#### ***Other Commitments***

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2015, are as follows: 2016, \$220 thousand; 2017, \$125 thousand; 2018, \$35 thousand; 2019, \$30 thousand; 2020, \$3 thousand.

#### ***Contingent Liabilities***

The Company and the Bank are involved in various legal proceedings, arising in connection with their business. In the opinion of management, based upon consultation with legal counsel, the ultimate resolution of these proceeding will not have a material adverse effect upon the consolidated financial condition or results of operations of the Company and the Bank.

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**Table of Contents****NOTE 17: FAIR VALUE****Fair Value Hierarchy**

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

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

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

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

**Level changes in fair value measurements**

Transfers between levels of the fair value hierarchy are generally recognized at the end of the reporting period. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company's financial assets and liabilities generally is such that transfers in and out of any level are expected to be infrequent. For the years ended December 31, 2015 and 2014, there were no transfers between levels and no changes in valuation techniques for the Company's financial assets and liabilities.

**Assets and liabilities measured at fair value on a recurring basis***Securities available-for-sale*

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

*Interest rate swap agreements*

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

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

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

<i>(Dollars in thousands)</i>	<b>Amount</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b>December 31, 2015:</b>				
Securities available-for-sale:				
Agency obligations	\$ 60,085		60,085	
Agency RMBS	110,954		110,954	
State and political subdivisions	70,648		70,648	
Total securities available-for-sale	241,687		241,687	
Other assets <sup>(1)</sup>	440		440	
<b>Total assets at fair value</b>	<b>\$ 242,127</b>		<b>242,127</b>	
Other liabilities <sup>(1)</sup>	440		440	
<b>Total liabilities at fair value</b>	<b>\$ 440</b>		<b>440</b>	
<b>December 31, 2014:</b>				
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 <sup>(1)</sup>	634		634	
<b>Total assets at fair value</b>	<b>\$ 268,237</b>		<b>268,237</b>	
Other liabilities <sup>(1)</sup>	634		634	
<b>Total liabilities at fair value</b>	<b>\$ 634</b>		<b>634</b>	

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

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

#### *Loans held for sale*

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

#### *Impaired Loans*

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

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 rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Periodically, the Company will review broker surveys and other market research to validate significant assumptions used in the model. The significant unobservable inputs include prepayment speeds or the constant prepayment rate (CPR) and the weighted average discount rate. Because the valuation of 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 December 31, 2015 and 2014, respectively, by caption, on the accompanying consolidated balance sheets and by ASC 820 valuation hierarchy (as described above):

<i>(Dollars in thousands)</i>	<b>Amount</b>	<b>Quoted Prices in</b>	<b>Other</b>	<b>Significant</b>
		<b>Active</b>	<b>Observable</b>	<b>Unobservable</b>
		<b>Markets</b>	<b>Inputs</b>	<b>Inputs</b>
		<b>for</b>	<b>(Level 2)</b>	<b>(Level 3)</b>
		<b>Identical Assets</b>		

**(Level  
1)****December 31, 2015:**

Loans held for sale	\$	1,540	1,540	
Loans, net <sup>(1)</sup>		3,286		3,286
Other real estate owned		252		252
Other assets <sup>(2)</sup>		2,316		2,316
Total assets at fair value	\$	7,394	1,540	5,854

**December 31, 2014:**

Loans held for sale	\$	1,974	1,974	
Loans, net <sup>(1)</sup>		3,077		3,077
Other real estate owned		534		534
Other assets <sup>(2)</sup>		2,388		2,388
Total assets at fair value	\$	7,973	1,974	5,999

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

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



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At December 31, 2015 and 2014 and for the years then ended, the Company had no Level 3 assets measured at fair value on a recurring basis. For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2015, the significant unobservable inputs used in the fair value measurements are presented below.

<i>(Dollars in thousands)</i>	<b>Carrying</b>			<b>Weighted</b>
	<b>Amount</b>	<b>Valuation Technique</b>	<b>Significant Unobservable Input</b>	<b>Average</b>
				<b>of Input</b>
<b>Nonrecurring:</b>				
Impaired loans	\$ 3,286	Appraisal	Appraisal discounts (%)	25.7%
Other real estate owned	252	Appraisal	Appraisal discounts (%)	6.0%
Mortgage servicing rights, net	2,316	Discounted cash flow	Prepayment speed or CPR (%)	10.0%
			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 market secondary market prices for similar loans.

***Time Deposits***

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

***Long-term debt***

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

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The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company's financial instruments at December 31, 2015 and 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, interest-bearing demand, and savings deposits due to these products having no stated maturity. In addition, financial liabilities for which fair value approximates carrying value included overnight borrowings such as federal funds purchased and securities sold under agreements to repurchase.

	<b>Fair Value Hierarchy</b>				
	<b>Carrying</b>	<b>Estimated</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<i>(Dollars in thousands)</i>	<b>amount</b>	<b>fair value</b>	<b>inputs</b>	<b>inputs</b>	<b>Inputs</b>
<b>December 31, 2015:</b>					
Financial Assets:					
Loans, net (1)	\$ 422,121	\$ 427,340	\$	\$	\$ 427,340
Loans held for sale	1,540	1,574		1,574	
Financial Liabilities:					
Time Deposits	\$ 219,598	\$ 220,093	\$	\$ 220,093	\$
Long-term debt	7,217	7,217		7,217	
<b>December 31, 2014:</b>					
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.

**NOTE 18: RELATED PARTY TRANSACTIONS**

A former director who retired from the Company's board of directors in October 2015, is an officer in a construction company that the Company contracted with in 2015 and 2014 for limited renovations at the Bank's operations center, the build out of leasehold improvements in connection with a relocation of a bank branch, and for construction of a new branch facility located in Auburn, Alabama. Total payments made to the construction company under the terms of these contracts were \$1.2 million and \$0.1 million for the years ended December 31, 2015 and 2014, respectively.

The Bank has made, and expects in the future to continue to make in the ordinary course of business, loans to directors and executive officers of the Company, the Bank, and their affiliates. In management's opinion, these loans were made

in the ordinary course of business at normal credit terms, including interest rate and collateral requirements, and do not represent more than normal credit risk. An analysis of such outstanding loans is presented below.

<i>(Dollars in thousands)</i>	<b>Amount</b>
Loans outstanding at December 31, 2014	\$ 4,841
New loans/advances	1,428
Repayments	(1,457)
Changes in directors and executive officers	(1,097)
Loans outstanding at December 31, 2015	\$ 3,715

During 2015 and 2014, certain executive officers and directors of the Company and the Bank, including companies with which they are affiliated, were deposit customers of the bank. Total deposits for these persons at December 31, 2015 and 2014 amounted to \$18.1 million and \$22.0 million, respectively.

**Table of Contents****NOTE 19: REGULATORY RESTRICTIONS AND CAPITAL RATIOS**

The Company and the Bank are subject to various regulatory capital requirements and policies administered by federal and State of Alabama banking regulators. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on the consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors, including anticipated capital needs. Supervisory assessments of capital adequacy may differ significantly from conclusions based solely upon risk-based capital ratios. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) common equity Tier 1 ratio, Tier 1 leverage ratio, Tier 1 risk-based ratio and total risk-based ratio. Management believes, as of December 31, 2015, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2015, the Bank is well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum common equity Tier 1, total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. Management has not received any notification from the Company's or the Bank's regulators that changes the Bank's regulatory capital status.

The actual capital amounts and ratios and the aforementioned minimums as of December 31, 2015 and 2014 are presented below.

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<i>(Dollars in thousands)</i>						
<b>At December 31, 2015:</b>						
Tier 1 Leverage Capital						
Auburn National Bancorporation	\$ 84,268	10.35 %	\$ 32,553	4.00 %	N/A	N/A
AuburnBank	82,848	10.19	32,519	4.00	\$ 40,649	5.00 %
Common Equity Tier 1 Capital						
Auburn National Bancorporation	\$ 77,714	15.28 %	\$ 22,886	4.50 %	N/A	N/A
AuburnBank	82,848	16.26	22,933	4.50	\$ 33,125	6.50
Tier 1 Risk-Based Capital						
	\$ 84,268	16.57 %	\$ 30,515	6.00 %	N/A	N/A

Auburn National Bancorporation							
AuburnBank	82,848	16.26	30,577	6.00	\$	40,769	8.00 %

## Total Risk-Based Capital

Auburn National Bancorporation							
	\$	88,682	17.44 %	\$	40,687	8.00 %	N/A
AuburnBank		87,262	17.12		40,769	8.00	\$ 50,962 10.00 %

**At December 31, 2014:**

## Tier 1 Leverage Capital

Auburn National Bancorporation							
	\$	80,356	10.32 %	\$	31,133	4.00 %	N/A
AuburnBank		78,968	10.16		31,099	4.00	\$ 38,873 5.00 %

## Tier 1 Risk-Based Capital

Auburn National Bancorporation							
	\$	80,356	17.45 %	\$	18,419	4.00 %	N/A
AuburnBank		78,968	17.11		18,463	4.00	\$ 27,695 6.00 %

## Total Risk-Based Capital

Auburn National Bancorporation							
	\$	85,356	18.54 %	\$	36,839	8.00 %	N/A
AuburnBank		83,968	18.19		36,927	8.00	\$ 46,158 10.00 %

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Dividends paid by the Bank are a principal source of funds available to the Company for payment of dividends to its stockholders and for other needs. Applicable federal and state statutes and regulations impose restrictions on the amounts of dividends that may be declared by the subsidiary bank. State law and Federal Reserve policy restrict the Bank from declaring dividends in excess of the sum of the current year's earnings plus the retained net earnings from the preceding two years without prior approval. In addition to the formal statutes and regulations, regulatory authorities also consider the adequacy of the Bank's total capital in relation to its assets, deposits, and other such items. Capital adequacy considerations could further limit the availability of dividends from the Bank. At December 31, 2015, the Bank could have declared additional dividends of approximately \$12.3 million without prior approval of regulatory authorities. As a result of this limitation, approximately \$73.2 million of the Company's investment in the Bank was restricted from transfer in the form of dividends.

**NOTE 20: AUBURN NATIONAL BANCORPORATION (PARENT COMPANY)**

The Parent Company's condensed balance sheets and related condensed statements of earnings and cash flows are as follows:

**CONDENSED BALANCE SHEETS**

	<b>December 31</b>	
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
<b>Assets:</b>		
Cash and due from banks	\$ 2,187	2,311
Investment in bank subsidiary	85,529	81,410
Other assets	845	846
<b>Total assets</b>	<b>\$ 88,561</b>	<b>84,567</b>
<b>Liabilities:</b>		
Accrued expenses and other liabilities	\$ 1,395	1,551
Long-term debt	7,217	7,217
<b>Total liabilities</b>	<b>8,612</b>	<b>8,768</b>
Stockholders' equity	79,949	75,799
<b>Total liabilities and stockholders' equity</b>	<b>\$ 88,561</b>	<b>84,567</b>

**CONDENSED STATEMENTS OF EARNINGS****Year ended December 31**

<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
<b>Income:</b>		
Dividends from bank subsidiary	\$ 3,450	3,377
Noninterest income	135	147
Total income	3,585	3,524
<b>Expense:</b>		
Interest expense	236	236
Noninterest expense	195	206
Total expense	431	442
Earnings before income tax benefit and equity in undistributed earnings of bank subsidiary	3,154	3,082
Income tax benefit	(80)	(114)
Earnings before equity in undistributed earnings of bank subsidiary	3,234	3,196
Equity in undistributed earnings of bank subsidiary	4,624	4,252
<b>Net earnings</b>	<b>\$ 7,858</b>	<b>7,448</b>



**Table of Contents****CONDENSED STATEMENTS OF CASH FLOWS**

	<b>Year ended December 31</b>	
<i>(Dollars in thousands)</i>	<b>2015</b>	<b>2014</b>
<b>Cash flows from operating activities:</b>		
Net earnings	\$ 7,858	7,448
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Net decrease in other assets	1	
Net decrease in other liabilities	(153)	(159)
Equity in undistributed earnings of bank subsidiary	(4,624)	(4,252)
<b>Net cash provided by operating activities</b>	<b>3,082</b>	<b>3,037</b>
<b>Cash flows from financing activities:</b>		
Dividends paid	(3,206)	(3,134)
<b>Net cash used in financing activities</b>	<b>(3,206)</b>	<b>(3,134)</b>
<b>Net change in cash and cash equivalents</b>	<b>(124)</b>	<b>(97)</b>
Cash and cash equivalents at beginning of period	2,311	2,408
<b>Cash and cash equivalents at end of period</b>	<b>\$ 2,187</b>	<b>2,311</b>

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**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

Information required by this item is set forth under the headings Proposal One: Election of Directors Information about Nominees for Directors, and Executive Officers, Additional Information Concerning the Company's Board of Directors and Committees, Executive Compensation, Audit Committee Report and Compliance with Section 16(a) of the Securities Exchange Act of 1934 in the Proxy Statement, and is incorporated herein by reference.

The Board of Directors has adopted a Code of Conduct and Ethics applicable to the Company's directors, officers and employees, including the Company's principal executive officer, principal financial and principal accounting officer, controller and other senior financial officers. The Code of Conduct and Ethics, as well as the charters for the Audit Committee, Compensation Committee, and the Nominating and Corporate Governance Committee, can be found by hovering over the heading About Us on the Company's website, [www.auburnbank.com](http://www.auburnbank.com), and then clicking on Investor Relations, and then clicking on Governance Documents. In addition, this information is available in print to any shareholder who requests it. Written requests for a copy of the Company's Code of Conduct and Ethics or the Audit Committee, Compensation Committee, or Nominating and Corporate Governance Committee Charters may be sent to Auburn National Bancorporation, Inc., 100 N. Gay Street, Auburn, Alabama 36830, Attention: Marla Kickliter, Senior Vice President of Compliance and Internal Audit. Requests may also be made via telephone by contacting Marla Kickliter, Senior Vice President of Compliance and Internal Audit, or Laura Carrington, Vice President of Human Resources, at (334) 821-9200.

**ITEM 11. EXECUTIVE COMPENSATION**

Information required by this item is set forth under the headings Additional Information Concerning the Company's Board of Directors and Committees Board Compensation, and Executive Officers in the Proxy Statement, and is incorporated herein by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information required by this item is set forth under the headings Proposal One: Election of Directors Information about Nominees for Directors and Executive Officers and Stock Ownership by Certain Persons in the Proxy Statement, and is incorporated herein by reference.

As of December 31, 2015 the Company had no compensation plans under which equity securities of the Company are authorized for issuance.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

Information required by this item is set forth under the headings Additional Information Concerning the Company's Board of Directors and Committees Committees of the Board of Directors Independent Directors Committee and Certain Transactions and Business Relationships in the Proxy Statement, and is incorporated herein by reference.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

Information required by this item is set forth under the heading "Independent Public Accountants" in the Proxy Statement, and is incorporated herein by reference.

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**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) List of all Financial Statements

The following consolidated financial statements and report of independent registered public accounting firm of the Company are included in this Annual Report on Form 10-K:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2015 and 2014

Consolidated Statements of Earnings for the years ended December 31, 2015 and 2014

Consolidated Statements of Comprehensive Income for the years ended December 31, 2015 and 2014

Consolidated Statements of Stockholders' Equity for the years ended December 31, 2015 and 2014

Consolidated Statements of Cash Flows for the years ended December 31, 2015 and 2014

Notes to the Consolidated Financial Statements

(b) Exhibits

- 3.1. Certificate of Incorporation of Auburn National Bancorporation, Inc. (incorporated by reference from Registrant's Form 10-Q dated June 20, 2002 (File No. 000-26486)).
- 3.2. Amended and Restated Bylaws of Auburn National Bancorporation, Inc., adopted as of November 13, 2007 (incorporated by reference from Registrant's Form 10-K dated March 31, 2008 (File No. 000-26486)).
- 4.1 Junior Subordinated Indenture, dated as of November 4, 2003, between Auburn National Bancorporation, Inc. and Wilmington Trust Company, as trustee (incorporated by reference from Registrant's Form 10-Q dated November 14, 2003 (File No. 000-26486)).
- 4.2 Amended and Restated Trust Agreement, dated as of November 4, 2003, among Auburn National Bancorporation, Inc., as Depositor, Wilmington Trust Company, as Property Trustee, Wilmington Trust Company, as Delaware Trustee and the Administrative Trustees named therein, as Administrative Trustees (incorporated by reference from Registrant's Form 10-Q dated November 14, 2003 (File No. 000-26486)).
- 4.3 Guarantee Agreement dated as of November 4, 2003, between Auburn National Bancorporation, Inc., as Guarantor, and Wilmington Trust Company, as Guarantee Trustee (incorporated by reference from Registrant's Form 10-Q dated November 14, 2003 (File No. 000-26486)).
- 21.1 Subsidiaries of Registrant

- 31.1 Certification signed by the Chief Executive Officer pursuant to SEC Rule 13a-14(a).
  - 31.2 Certification signed by the Chief Financial Officer pursuant to SEC Rule 13a-14(a).
  - 32.1 Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002 by E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board. \*
  - 32.2 Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002 by David A. Hedges, EVP, Chief Financial Officer.\*
- 101.INS XBRL Instance Document
  - 101.SCH XBRL Taxonomy Extension Schema Document
  - 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

**Table of Contents**

101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

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

(c) Financial Statement Schedules

All financial statement schedules required pursuant to this item were either included in the financial information set forth in (a) above or are inapplicable and therefore have been omitted.

Table of Contents**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Auburn, State of Alabama, on March 10, 2016.

AUBURN NATIONAL BANCORPORATION, INC.  
(Registrant)

By: /S/ E. L. SPENCER, JR.  
E. L. Spencer, Jr.  
President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
<u>/S/ E. L. SPENCER, JR.</u>	President, CEO and Chairman of the Board	March 10, 2016
E. L. Spencer, Jr.	(Principal Executive Officer)	
<u>/S/ DAVID A. HEDGES</u>	EVP, Chief Financial Officer	March 10, 2016
David A. Hedges	(Principal Financial Officer)	
<u>/S/ C. WAYNE ALDERMAN</u>	Director	March 10, 2016
C. Wayne Alderman		
<u>/S/ TERRY W. ANDRUS</u>	Director	March 10, 2016
Terry W. Andrus		
<u>/S/ J. TUTT BARRETT</u>	Director	March 10, 2016
J. Tutt Barrett		
<u>/S/ ROBERT W. DUMAS</u>	Director	March 10, 2016
Robert W. Dumas		
<u>/S/ WILLIAM F. HAM, JR.</u>	Director	March 10, 2016
William F. Ham, Jr.		

<u>/S/ DAVID E. HOUSEL</u>	Director	March 10, 2016
David E. Housel		
<u>/S/ ANNE M. MAY</u>	Director	March 10, 2016
Anne M. May		
<u>/S/ AMY B. MURPHY</u>	Director	March 10, 2016
Amy B. Murphy		
<u>/S/ EDWARD LEE SPENCER, III</u>	Director	March 10, 2016
Edward Lee Spencer, III		
<u>/S/ DR. PATRICIA WADE</u>	Director	March 10, 2016
Dr. Patricia Wade		



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