AUBURN NATIONAL BANCORPORATION INC
Form 10-K
March 30, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2009

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:

Title of Each Class	**Name of Exchange on which Registered**
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 þ

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 þ

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 þ 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. þ

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

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

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

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: $66,527,009 as of June 30, 2009.

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: 3,643,112 shares of common stock as of March 10, 2010.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Annual Meeting of Shareholders, scheduled to be held May 11, 2010, 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 or achievements of the Company to be materially different from future results, performance or achievements 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, cont expect, estimate, continue, further, plan, point to, project, could, intend, target and other similar words and expressions of the forward-looking statements may not be realized due to a variety of factors, including, without limitation:

- the effects of future economic, business and market conditions and changes, domestic and foreign, including seasonality;
- governmental monetary and fiscal policies;
- legislative and regulatory changes, including changes in banking, securities and tax laws, regulations and rules and their application by our regulators, and changes in the scope and cost of FDIC insurance and other coverage;
- changes in accounting policies, rules and practices;
- the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities;
- changes in borrower credit risks and payment behaviors;
- changes in the availability and cost of credit and capital in the financial markets;
- 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;

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

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

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

- other factors and 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.

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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, regulations and rules. 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 in East Alabama, including Lee County and surrounding areas. The Bank has been a member of the Federal Reserve System since April 1995 (the Charter Conversion). 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*. The Company is not incorporating the information on that website into this report, and the website and the information appearing on the website are not included 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 that contains reports, proxy, and other information Our SEC filings are also available to the public free of charge from the SEC s web site at *www.sec.gov*.

The Bank has two direct, wholly-owned subsidiaries, with immaterial operations:

Banc of Auburn, Inc.
Auburn Mortgage Corporation

The Company directly owns all the common equity in one statutory trust, Auburn National Bancorporation Capital Trust I, an Alabama statutory trust, which was formed in 2003 for the purpose of issuing $7.0 million floating capital securities in order to repurchase the Bank s outstanding common shares.

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 (PSA). The Bank s PSA 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 13 locations in its PSA. 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*.

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.

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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 may also have substantially higher lending limits than the Bank.

Community 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

As described above, the Bank s PSA is primarily in Lee County. Outside of the Bank s PSA, the Bank has a mortgage loan production office in Mountain Brook, a Birmingham suburb. Lee County s population was approximately 133,010 in 2008, and has increased approximately 15.6% from 2000 to 2008. In 2008, the Auburn-Opelika Metropolitan Statistical Area (MSA), which includes Lee County, was named one of the fastest growing small MSAs in the nation by Forbes Magazine. The largest employers in the area are Auburn University, East Alabama Medical Center, a Wal-Mart Distribution Center, and Briggs & Stratton.

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 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. These standards are used to determine the creditworthiness of the borrower at the time a loan is made and are monitored periodically throughout the life of the loan. See Legislative and Regulatory Changes for a discussion of recent regulatory guidance on commercial real estate lending.

The Bank has loans outstanding to borrowers in all industries within its PSA. 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. However, management believes that due to the diversified mix of industries located within the Bank s PSA, 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 PSA is also subject to both local and national economic conditions and fluctuations.

Employees

At December 31, 2009, the Company and its subsidiaries had 154 full-time equivalent employees, including 33 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

Bank holding companies and banks are extensively regulated under federal and state law. This discussion is qualified in its entirety by reference to the particular statutory and regulatory provisions referred to below and is not intended to be a complete description of the status or regulations applicable to the Company s and the Bank s business. The supervision, regulation and examination of the Company and the Bank and their respective subsidiaries by the bank regulatory agencies are intended primarily for 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.

Bank Holding Company Regulation

The Company, as a bank holding company, is subject to supervision and regulation 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.

The Gramm-Leach-Bliley Act of 1999 (the GLB Act) revised the statutory restrictions separating banking activities from certain other financial activities. Under the GLB Act, bank holding companies that are well-capitalized and well-managed, as defined in Federal Reserve Regulation Y, and whose subsidiary banks have and maintain satisfactory or better ratings under the Community Reinvestment Act of 1977, as amended (the CRA), and meet certain other conditions can 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 merchant banking authority added by the GLB Act 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 of the financial holding company s controlled depository institutions. Financial holding companies continue to be subject to the oversight and supervision of the Federal Reserve, but 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, such that the Company and any other bank holding company, whether located in Alabama or elsewhere, may acquire a bank located in any other state, subject to certain deposit-percentage, age of bank charter requirements, and other restrictions. Federal law also permits national and state-chartered banks to branch interstate through acquisitions of banks in other states. Alabama permits interstate branching. Under the Alabama Banking Code, with the prior approval of the Alabama Superintendent, an Alabama bank, may establish, maintain and operate one or more banks in a state other than the State of Alabama pursuant to a merger transaction in which the Alabama bank is the resulting 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 maintain and operate the branches of the Alabama bank that participated in such merger. Alabama banks may branch into other states, if federal and state law permits, and out-of-state banks may branch into Alabama, if its home state permits Alabama banks to branch into that state.

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 Section 23A 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 acceptable collateral, generally United States government or agency securities. The Company and the Bank also are subject to Section 23B of the Federal Reserve Act, which 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 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 troubled bank may not otherwise be warranted. 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 Federal Deposit Insurance Corporation (FDIC) as a result of an affiliated depository institution s failure. As

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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 perhaps to other creditors of the bank.

The Federal Reserve has proposed guidelines for employee compensation to reduce incentives to take undue risks.

Bank and Bank Subsidiary 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 of 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 with competitive equality to the powers of national banks.

In 2007, the Alabama legislature amended the Alabama Banking Code to, among other things, allow Alabama banks to establish *de novo* branches in other states, and to allow out-of-state banks that do not already operated a branch in Alabama to establish *de novo* branches in Alabama, provided the laws of the home state of such out-of-state bank allow Alabama banks to establish *de novo* branches in such state. This legislation also strengthens 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 including Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity 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 nontrading positions.

The GLB Act and related regulations requires banks and their affiliated companies to adopt and disclose privacy policies, including policies regarding the sharing of personal information they obtain from customers 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

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 community 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 branch 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 on Discrimination in Lending in order 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.

Other Laws and Regulations

The GLB Act requires banks and their affiliated companies to adopt and disclose privacy policies regarding the sharing of personal information they obtain from their customers with third parties. The GLB Act also permits bank subsidiaries to engage in financial activities through subsidiaries similar to those permitted to financial holding companies. See the discussion regarding the GLB Act in Bank Holding Company Regulation above.

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 (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 Federal Reserve, the FDIC 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 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.

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, 2009 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 s fails to comply with these internal control rules, it may materially adversely affect its reputation, its ability to obtain the necessary certifications to its financial statements, and the values of its securities. The Company s assessment of its financial reporting controls as of December 31, 2009 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 2009, the Bank paid cash dividends of approximately $3.0 million to the Company.

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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 adequate capital above regulatory minimums. The appropriate federal and state regulatory authorities are authorized to determine 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 out of current year s operating earnings.

Under a Federal Reserve policy adopted in 2009, 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.

Capital

The Federal Reserve has risk-based capital guidelines for bank holding companies and state member banks, respectively. These guidelines require 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, retained earnings and a limited amount of qualifying preferred stock, less goodwill and certain core deposit intangibles (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 Capital). The Federal Reserve believes that Tier 1 voting common equity should be the predominant form of capital.

In addition, the federal regulatory agencies have established minimum leverage ratio guidelines for bank holding companies 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 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 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 qualify 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.

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 adopted regulations establishing relevant capital measures and relevant capital levels. The relevant capital measures are the Total Capital ratio, Tier 1 capital ratio and the leverage ratio. Under the regulations, a state member bank will be: (i) well capitalized if it has a Total Capital ratio of 10% or greater, a

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Tier 1 capital ratio of 6% or greater, a Tier 1 leverage 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 meet and maintain a specific capital level for any capital measure; (ii) adequately capitalized if it has a Total Capital ratio of 8% or greater, a Tier 1 capital ratio of 4% or greater, and a leverage ratio of 4% or greater (3% in certain circumstances); (iii) undercapitalized if it has a Total Capital ratio of less than 8%, a Tier 1 capital ratio of less than 4% (3% in certain circumstances); (iv) significantly undercapitalized if it has a Total Capital ratio of less than 6%, a Tier 1 capital ratio of less than 3% and a leverage ratio of less than 3%; or (v) critically undercapitalized if its tangible equity is equal to or less than 2% of average quarterly tangible 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. In addition, changes may be proposed in the capital rules and new rules regarding liquidity also may be proposed.

The Federal Reserve s revised trust preferred capital rules, which took effect in early April 2006, permit the Company to treat its outstanding trust preferred securities as Tier 1 Capital for the first 25 years of the 30 year term of the related junior subordinated debentures. During the last five years preceding maturity, the amount included as capital will decline 20% per year.

Information concerning the Company s and the Bank s regulatory capital ratios at December 31, 2009 is included in Note 18 to the Consolidated Financial Statements.

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 would thereafter 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 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.

FDICIA

FDICIA also 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, 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 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.

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 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.

Beginning in 2008, the Federal Reserve took various actions to increase market liquidity and reduce interest rates.

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. The Federal Reserve s discount rate was reduced on December 16, 2008 to its current rate of 0.50% per annum, down from 5.75% on September 17, 2007, 4.75% on January 2, 2008, and 1.25% on October 29, 2008. The Federal Reserve has extended the term for which banks can borrow from the discount window to up to 90 days; and developed a program, called the Term Auction Facility, under which predetermined amounts of credit are auctioned to depository institutions for terms of up to 84 days. These innovations resulted in large increases in the amount of Federal Reserve credit extended to the banking system.

In addition, the Federal Reserve and the Treasury have jointly announced a Term Asset-Backed Securities Loan Facility (TALF) that will lend against AAA-rated asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. TALF is expiring on March 31, 2010, except for qualifying newly-issued commercial mortgage-backed securities (CMBS) which are scheduled to expire on June 30, 2010.

The Federal Reserve announced on November 28, 2008 that it was initiating a program to purchase the direct obligations of housing-related government-sponsored enterprises (GSEs) Fannie Mae, Freddie Mac, and the Federal Home Loan Banks and mortgage-backed securities (MBS) backed by Fannie Mae, Freddie Mac, and Ginnie Mae. This action was taken to reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally. In the week ending February 3, 2010, the Federal Reserve purchased a total of $17.63 billion agency MBS under this program. This program is set to expire on March 31, 2010.

Beginning October 6, 2008, the Federal Reserve began 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.

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 is subject to FDIC deposit insurance assessments. The Bank s deposits are insured by the FDIC s Deposit Insurance Fund (DIF). The Bank is subject to FDIC assessments for such deposit insurance, as well as assessments by the FDIC to pay interest on the Financing Corporation (FICO) bonds. During 2006 through 2008, the FDIC s risk based deposit insurance assessments schedule ranged from zero to 43 basis points per annum. During 2007, the Bank paid no FDIC deposit insurance premiums and in 2008, the Bank paid approximately $226 thousand in FDIC deposit insurance premiums and the FDIC deposit insurance premiums paid were increased to approximately $1.2 million in 2009. FICO assessments of approximately $63 thousand, $60 thousand and $59 thousand were paid to the FDIC in 2009, 2008 and 2007, respectively.

Congress passed the Federal Deposit Insurance Reform Act (the Reform Act) in February 2006. As a result, deposits remained insured up to a maximum of $100,000, but the amount of deposit insurance will be adjusted every five years based upon inflation. Retirement accounts were insured for up to $250,000, and banks that are less than adequately capitalized will be unable to accept employee benefit deposits. This law also changed the way FDIC insurance assessments and credits are calculated. The Emergency Economic Stabilization Act of 2008 (EESA) temporarily increased FDIC deposit insurance to $250,000 per depositor through December 31, 2009. EESA provides that the temporary increase in deposit insurance coverage is not taken into account for FDIC insurance assessment purposes.

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Effective January 1, 2009, the FDIC has increased it deposit insurance assessment rates uniformly by 7 basis points annually for the first quarter 2009 assessment period. Annual rates applicable to the first quarter 2009 assessments, which will be collected at the end of June, are as follows:

	First Quarter 2009	Second Quarter 2009
Risk Category	**Assessment Rate**	**Assessment Rate**
I	12 to 14 basis points	12 to 16 basis points
II	17 basis points	22 basis points
III	35 basis points	32 basis points
IV	50 basis points	45 basis points

The FDIC issued another final rule effective April 1, 2009, to change the way that the FDIC s assessment system differentiates for risk, make corresponding changes to assessment rates beginning with the second quarter of 2009, as well as other changes to the deposit insurance assessment rules. In addition, a one-time special assessment was imposed for the second quarter of 2009 only, based on the total assets of the Bank, and resulting in an additional $0.4 million of premium paid. The FDIC s new rules include a decrease for long-term unsecured debt, including senior and subordinated debt and, for small institutions with assets under $10 billion, a portion of Tier 1 capital; (2) an increase for secured liabilities above a threshold amount; and (3) an increase for brokered deposits above a threshold amount. The new assessment rules increase assessments for banks that use brokered deposits above a threshold level to fund rapid asset growth. In 2009, the Bank paid $1.2 million in FDIC insurance premiums, including $0.4 million for a special industry-wide FDIC deposit insurance assessment. In addition, to restore the FDIC s Deposit Insurance Fund, all FDIC-insured institutions were required to prepay their deposit premiums for 3 years. On December 30, 2009, the Bank prepaid $3.5 million of FDIC insurance premiums for the calendar quarters ending December 31, 2009 through December 31, 2012. Additionally, in January 2010, the FDIC issued an Advance Notice of Proposed Rulemaking seeking comment on ways that the FDIC s risk-based deposit insurance assessment system could be changed to account for the risks posed by certain employee compensation programs.

FICO assessments are set by the FDIC quarterly and ranged from 1.22 basis points in the first quarter of 2007 to 1.14 basis points in the last quarter of 2007, 1.14 basis points in the first quarter of 2008 to 1.10 basis points in the last quarter of 2008, and 1.14 basis points in the first quarter of 2009 to 1.02 basis points in the last quarter of 2009. The FICO assessment rate for the first quarter of 2010 is 1.06 basis points.

Under the FDIC s Temporary Liquidity Guarantee Program (the TLG), the entire amount in any eligible noninterest bearing transaction accounts will be guaranteed by the FDIC to the extent such balances are not covered by FDIC insurance. The TLG also provides FDIC guarantees to newly issued senior unsecured debt of banks and holding companies. The TLG debt guarantee program expired on December 31, 2009, and the Bank has not opted out from the extension of the transaction account guarantee program which is scheduled to expire on June 30, 2010. The Company and the Bank did not issue any guaranteed debt under TLG. Banks that participate in the TLG s extended noninterest bearing transaction account guarantee program will pay the FDIC an increased fee of 15 to 25 basis points depending on an institution s risk category for deposit insurance purposes. To the extent that these TLG assessments are insufficient to cover any loss or expenses arising from the TLG program, the FDIC is authorized to impose an emergency special assessment on FDIC-insured depository institutions. Legislation has been proposed to give the FDIC authority to impose charges for the TLG program upon depository institution holding companies, as well.

Emergency Economic Stabilization Act of 2008

EESA was enacted on October 3, 2008. EESA authorizes the Treasury to use up to $700 billion to buy troubled assets, provide capital, or otherwise provide assistance to U.S. banks, thrifts and their holding companies (TARP). Pursuant to authority granted under EESA, the Secretary has created the TARP Capital Purchase Program (the CPP) under which the Treasury will invest up to $250 billion in senior preferred stock of U.S. banks and savings associations or their holding companies. Qualifying financial institutions may issue senior preferred stock with a value equal to not less than 1% of risk-weighted assets and not more than the lesser of $25 billion or 3% of risk-weighted assets.

When an institution participates in the CPP, it will be subject to the Treasury s standards for executive compensation and corporate governance as long as the Treasury holds the equity issued under the CPP. These standards generally apply to our chief executive officer, chief financial officer and the three next most highly compensated senior executive officers. The standards include (1) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (2) required clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (3) prohibition on making golden parachute payments to senior executives; and (4) an agreement not to deduct for tax purposes executive compensation in excess of $500,000 for each senior executive.

On February 17, 2009, the ARRA became law. The ARRA apparently retroactively imposes certain new executive compensation and corporate expenditure limits and corporate governance standards on all current and future TARP recipients that are in addition to those previously announced by the Treasury, until the institution has repaid the Treasury.

On February 10, 2009, the Treasury announced the Financial Stability Plan, which earmarked the second $350 billion of TARP funds authorized under the EESA. Among other things, the Financial Stability Plan include:

A capital assistance program (CAP) that will invest in mandatory convertible preferred stock of certain qualifying institutions determined on a basis and through a process similar to the TARP CPP;

A consumer and business lending initiative to fund new consumer loans, small business loans and commercial mortgage asset-backed securities issuances;

A new public-private investment fund that will leverage public and private capital with public financing to purchase up to $500 billion to $1 trillion of legacy toxic assets from financial institutions, and

Assistance for homeowners by providing up to $75 billion to reduce mortgage payments and interest rates and establishing loan modification guidelines for government and private programs.

We have elected not to participate in the TARP CPP and do not anticipate participating in the CAP although we believe we were eligible and would have been approved for the TARP CPP. However, we cannot predict the effect that EESA, ARRA, Financial Stability Plan, or PPIP may have on us or our business, financial condition or results of operations.

A new program for banks with assets under $10 billion of assets has been proposed as incentives for banks to increase their small business lending. This program may not be subject to various TARP restrictions. However, it is unclear if the proposal will be adopted by the Congress, and whether we will be able to participate in the new program or convert our current CPP investment. The requirements and constraints of this proposal are not yet known.

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 CRE loan concentrations exceed either:

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 of 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.

The Guidance did not apply to the Bank s CRE lending activities at year-end 2009. At December 31, 2009, the Bank had outstanding $56.8 million in construction and land development loans and $114.2 million in total CRE loans (excluding owner occupied), which represents approximately 87.6% and 176.0%, respectively, of the bank s total risk-based capital at December 31, 2009. 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 improvements in its loan and credit monitoring and administration procedures, are generally appropriate to managing its concentrations as required under the Guidance. The federal bank regulators are looking more closely at the risks of various assets and asset categories and risk management, and the need for additional rules regarding liquidity, as well as capital rules that better reflect risk.

On February 18, 2009, the Homeowner Affordability and Stability Plan (HASP) was announced by the President of the United States. HASP is intended to support a recovery in the housing market and ensure that workers can continue to pay off their mortgages through the following elements:

Provide access to low-cost refinancing for responsible homeowners suffering from falling home prices.

A $75 billion homeowner stability initiative to prevent foreclosure and help responsible families stay in their homes.

Support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac.

The Treasury has issued extensive guidance on the scope and mechanics of various components of HASP. We continue to monitor these developments and assess their potential impact on our business.

Financial Regulatory Reform

Congress is considering extensive changes to the laws regulating financial services firms. In December 2009, the House of Representatives approved the Wall Street Reform and Consumer Protection Act. The Senate Banking Committee approved its own version, Restoring American Financial Stability Act of 2010, on March 22, 2010.

These bills seek to address risks to the economy and the financial system, especially those posed by large systemically significant financial firms, through a variety of measures, including regulatory oversight of nonbanking entities, increased capital requirements, enhanced authority to limit activities and growth, changes in supervisory authority, resolution authority for failed financial firms (and the establishment of a fund to pay for the costs financed by assessments on financial firms with more than $10 billion in assets), enhanced regulation of derivatives and asset-backed securities, restrictions on executive compensation, and oversight of credit rating agencies. Both bills currently contain versions of a new independent Consumer Financial Protection Agency (CFPA) that would regulate consumer financial services and products, including credit, savings and payment products to prevent unfair, deceptive or abusive practices, promote product simplicity and ensure equal access to financial products. The CFPA would have sole rulemaking and interpretive authority under existing and future consumer financial services laws and supervisory, examination and enforcement authority over institutions subject to its regulations. The bills would limit the ability of federal laws to preempt state and local law. If implemented, the foregoing regulatory reforms may have a material effect on our operations. However, the final legislation may differ significantly from the legislation currently being considered. The nature and timing of any financial services reform legislation and its final terms as well as its effects cannot be predicted and we cannot determine the scope and specific impact on our Company of regulatory reform at this time.

Additionally, in January 2010, the Administration announced plans to propose a Financial Crisis Responsibility Fee over a 10-year period on large financial firms to offset the cost of the U.S. Treasury s Troubled Asset Relief Program. As currently outlined, we would not be subject to the fee because the size of our balance sheet will not exceed the $50 billion threshold established by the proposal. However, whether the fee will be implemented, and in what form, as well as its effects, are uncertain.

Legislative and Regulatory Changes

Various legislative and regulatory proposals 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.

The current stresses on the financial system and the economy generally and the powers granted to the Treasury under EESA and the ARRA make the nature and extent of future legislative and regulatory changes affecting financial institutions unpredictable and subject to rapid changes.

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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.

There can be no assurance that recent legislation and administrative actions authorizing the U.S. government to take direct actions within the financial services industry will help stabilize the U.S. financial system.

Numerous actions by the U.S. Congress, the Federal Reserve, the Treasury, the FDIC, the SEC and other governmental authorities to address the current liquidity and credit crisis that has followed the sub-prime mortgage crisis that commenced in 2007. These measures include various actions described under Fiscal and Monetary Policy and Recent Legislative and Regulatory Changes.

We cannot predict the actual effects of EESA, the ARRA and various governmental, regulatory, and fiscal and monetary initiatives which have been and may be enacted, adopted or proposed will have on the financial markets, our competitors and on us. The terms and costs of these activities, or the failure of these actions to help stabilize the financial markets, asset prices, market liquidity and a continuation or worsening of current financial market and economic conditions could materially and adversely affect our business, financial condition, results of operations, and the trading prices of our common stock.

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 have not been as adversely affected as various other areas of the country. Declines in the housing market over the past year, with falling home prices and increasing foreclosures, unemployment and under-employment, 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 have led to increased levels of commercial and consumer delinquencies, reduced consumer confidence, increased market volatility and reductions in business activity. Failures have increased among financial services companies, and various companies, weakened by market conditions, have merged with other institutions. We do not expect that the difficult conditions in the financial markets are likely to improve in the near future, although our business has not been materially affected through December 31, 2009. A worsening of these conditions would likely increase the adverse effects of these difficult market conditions on us and other financial institutions. In particular:

- We expect to face further increased regulation of our industry as a result of various initiatives by the U.S. government. Compliance with such regulations may increase our costs, reduce our profitability, and limit our ability to pursue business opportunities.

- Market developments may continue to affect consumer confidence levels 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 provision 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 other financial institutions on favorable terms or at all could be adversely affected by further disruptions in the capital markets or other events, including, among other things, deteriorating investor expectations.

Our investments in trust preferred securities and securities backed by pools of trust preferred securities, issued by, and loans and loan participations purchased from other financial institutions, and financial institutions in which we have common stock or equity investments could be materially and adversely affected, if these institutions exercise their rights to defer payment on their trust preferred securities, experience financial difficulties, defer payments on or reduce or eliminate dividends or distributions on their securities that we hold, are subject to regulatory enforcement actions, or fail.

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

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, 2009, the amortized cost of the Bank s investment in FHLB common stock, individual issuer trust preferred securities of financial institutions, and pooled trust preferred securities of other financial institutions was approximately $5.4 million, $3.4 million, and $0.3 million, respectively. In 2009, Silverton Bank, N.A., one of our correspondent banks, failed, which had a material adverse effect on our 2009 results of operations. Financial services institutions are interrelated as a result of 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 asset take significant time and adversely affect our results of operations and financial condition.

At December 31, 2009, our nonaccrual loans totaled $9.4 million, or 2.49% of the loan portfolio. In addition, we had approximately $7.3 million of other real estate owned at December 31, 2009. Our non-performing assets may adversely affect our net income in various ways. We do not record interest income on non-accrual loans or other real estate owned, thereby adversely affecting our income, and increasing our loan administration costs. Decreases in the value of these assets, or the underlying collateral, or in these borrowers performance or financial conditions, 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 further 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. 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 persist or 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.

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

The Lee County Association of Realtors (LCAR) of Alabama reported that the average median residential home price in Lee County for the quarter ended December 31, 2009 was $162,774, a decrease of 6.9% from the same quarter a year earlier. LCAR also reported that residential inventory at December 31, 2009 was 1,127 homes, a decrease of 2.3% from a year earlier. The average number of days on the market for the quarter ended December 31, 2009 was 166 days, a decrease of 2.9% from the same quarter last year. The effects of ongoing mortgage market challenges, combined with the ongoing correction in residential real estate market prices and reduced levels of home sales, could result in further 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. Declining real estate prices and higher interest rates charged on mortgage loans have caused higher delinquencies and losses on certain mortgage loans, generally, particularly second lien mortgages and home equity lines of credit. 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 and Freddie Mac loans. These trends could continue. Continued declines in real estate values, home sales volumes and financial stress on borrowers as a result of job losses, interest rate resets on adjustable rate mortgage loans or other factors could have further adverse effects on borrowers that result in higher delinquencies and greater charge-offs in future periods,

which would adversely affect our financial condition, including capital and liquidity, or our results of operations. In the event our allowance for loan losses is insufficient to cover such losses, our earnings, capital and liquidity could be adversely affected.

Our real estate portfolios are exposed to general weaknesses in the markets and the overall state of the economy.

The declines in home prices, generally, along with the reduced availability of mortgage credit, have resulted in increases in delinquencies and losses in our portfolios of home equity lines and loans, and commercial loans related to residential real estate acquisition, construction and development. Further declines in home prices coupled with an economic recession and associated rises in unemployment levels could drive losses beyond that which is provided for in our allowance for loan losses. In that event, our earnings, financial condition, including our capital and liquidity, could be adversely affected.

Our concentration of commercial real estate loans could result in further increased loan losses.

Commercial real estate (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 55.9% of our portfolio in CRE loans at year-end 2009 and 53.2% at year-end 2008. The banking regulators continue to give CRE lending greater scrutiny, 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.

Higher cost of insuring our deposits.

FDIC insurance premiums have increased substantially in 2009 already and we expect to pay significantly higher FDIC insurance premiums and guarantee fees in the future. Market developments have significantly depleted the FDIC s Deposit Insurance Fund and reduced the FDIC s ratio of reserves to insured deposits. The FDIC adopted a revised risk-based deposit insurance assessment schedule on February 27, 2009, which raised deposit insurance premiums. On May 22, 2009, the FDIC implemented a five basis point special assessment of each insured depository institution s assets minus Tier 1 capital as of June 30, 2009, but no more than 10 basis points times the institution s assessment base for the second quarter of 2009, collected on September 30, 2009. The FDIC has also required all FDIC-insured institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012, which we paid on December 30, 2009.

We also participated in the FDIC s TLG for noninterest-bearing transaction deposit accounts. Banks that participated in the TLG s noninterest-bearing transaction account guarantee paid the FDIC an annual assessment of 10 basis points on the amounts in such accounts above the amounts covered by FDIC deposit insurance. TLG s noninterest-bearing transaction deposit account guarantee program was scheduled to expire on December 31, 2009, but was extended to June 30, 2010. We have participated in the extended program. Institutions that participate in the extended program are required to pay an annualized fee of 15 to 25 basis points in accordance with their risk category rating assigned by the FDIC. To the extent that these TLG assessments are insufficient to cover any loss or expenses arising from the TLG program, the FDIC is authorized to impose an emergency special assessment on all FDIC-insured depository institutions. The FDIC has authority to impose charges for the TLG program upon depository institution holding companies, as well. The increased premiums and TLG assessments charged by the FDIC increased our noninterest expense in 2009 and we expect that it will continue to increase our noninterest expense in 2010.

Current levels of market volatility are unprecedented.

The capital and credit markets have been experiencing volatility and disruption for more than 12 months. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers underlying financial condition or performance. If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

Our ability to realize our 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 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, 2009, we had deferred tax assets of $3.7 million after we recorded $505,000 of valuation allowance based on management s estimation of the likelihood of those deferred tax assets being realized. 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 may be further reduced under Section 382 of the Internal Revenue Code by an offering and/or other sales of our capital securities.

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. 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.

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.

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

The Federal Reserve has taken aggressive actions to reduce interest rates generally, and the Federal government has approved large spending increases. Our cost of funds may increase as a result of general economic conditions, interest rates and competitive pressures, and potential inflation resulting from government deficit spending. 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. *See* Fiscal and Monetary Policy .

Our profitability and liquidity may be affected by changes in interest rates 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 such that 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. Monetary and fiscal policies may materially affect the level and direction of interest rates. From June 2004 to mid-2006, the Federal Reserve raised the federal funds rate from 1.0% to 5.25%. Since then, beginning in September 2007, the Federal Reserve decreased the federal funds rate by 100 basis points to 4.25% over the remainder of 2007, and has since reduced the target federal funds rate by an additional 400 basis points to zero to 25 basis points in December 2008. 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 have declined, generally in 2008, although Federal Reserve actions have recently improved the volume and cost in the residential mortgage market in early 2009. Declining rates reflect efforts by the Federal Reserve to stimulate the economy and may or may not be effective, and may affect our results of operation and financial condition, liquidity and earnings.

Liquidity risks could affect operations and jeopardize our financial condition.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans 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

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assets. We maintain a portfolio of securities that can be used as a secondary 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 issue and sell debt securities, and 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 could also be impaired by factors that are not specific to us, such as further disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued deterioration in credit markets, as well as the financial condition, liquidity and profitability of the financial institutions we deal with.

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, the effects of which 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.

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

From time to time, the Financial Accounting Standards Board (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.

We are subject to internal control reporting requirements that increase compliance costs and failure to comply timely could adversely affect our reputation and the value of our securities.

We are required to comply with various corporate governance and financial reporting requirements under the Sarbanes-Oxley Act of 2002, as well as rules and regulations adopted by the SEC, the Public Company Accounting Oversight Board and Nasdaq. In particular, we are required to report on internal controls as part of our annual report on Form 10-K pursuant to Section 404 of the Sarbanes-Oxley Act. We expect to continue to spend significant amounts of time and money on compliance with these rules. Our failure to comply with these internal control rules may materially adversely affect our reputation, ability to obtain the necessary certifications to financial statements, and the value of our securities.

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, our financial condition, liquidity and results of operations would be materially and adversely affected. Our failure to remain well capitalized and well managed 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 common stock, our ability to make acquisitions, and we would no longer meet the requirements for becoming a financial holding company.

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. 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. Our ability to raise additional capital, if needed, will depend, among other things, on conditions in the capital markets at that time, which are currently disrupted and 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.

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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. 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.

We may engage in FDIC-assisted transactions, which could present additional risks to our business.

We may have opportunities to acquire the assets and liabilities of failed banks in FDIC-assisted transactions, which present the risks of acquisitions, although generally, as well as some risks specific to these transactions. Although these FDIC-assisted transactions typically provide for FDIC assistance to an acquiror to mitigate certain risks, which may include loss-sharing, where the FDIC absorbs most losses on covered assets and provides some indemnity, we would be subject to many of the same risks we would face in acquiring another bank in a negotiated transaction, without FDIC assistance, including risks associated with pricing such transactions, the risks of loss of deposits and maintaining customer relationships and failure to realize the anticipated acquisition benefits in the amounts and within the timeframes we expect. In addition, because these acquisitions provide for limited diligence and negotiation of terms, these transactions may require additional resources and time, servicing acquired problem loans and costs related to integration of personnel and operating systems, the establishment of processes to service acquired assets, require us to raise additional capital, which may be dilutive to our existing shareholders. If we are unable to manage these risks, FDIC-assisted acquisitions could have a material adverse effect on our business, financial condition and results of operations.

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

While we seek continued organic growth, as our earnings and capital position improve, we 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. 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.

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. We may need to make significant additional capital investments in technology in the future, and we may not be able to effectively implement new technology-driven products and services. Many competitors have substantially greater resources to invest in technological improvements.

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

Severe weather, natural disasters, 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 .

Our common stock is not traded in large volumes.

Although our common stock is listed for trading in the Nasdaq Global Market, the trading volume in our common stock is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This also depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the lower trading volume of our common stock, significant sales of our common stock, or the expectation of these sales, could cause our stock price to fall.

ITEM 1B. UNRESOLVED STAFF COMMENTS
None.

ITEM 2. DESCRIPTION OF PROPERTY
The Bank conducts its business from its main office and nine full-service branches. The Bank also has three mortgage loan offices located in Mountain Brook, Phenix City and Valley, 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 building has paved parking for 84 vehicles, including four handicapped spaces. The main office offers the full line of the Bank s services and has two ATMs, including one walk-up ATM and one drive-through ATM. The Bank leases a drive-in facility located directly across the street from its main office. This drive-in facility has five drive-through lanes and a walk-up window.

The Bank s Auburn Kroger branch was opened in August 1988 and is located in the Kroger supermarket in the Corner Village Shopping Center in Auburn, Alabama. The bank leases approximately 500 square feet of space for this branch. In September 2008, the Bank entered into a new lease agreement with the Kroger Corporation for five years with options for two 5-year extensions. This branch offers the full line of the Bank s deposit and other services including an ATM, except safe deposit boxes.

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, including two handicapped spaces.

The Bank s Phenix City branch was opened in August 1998 in the Wal-Mart shopping center in Phenix City, Alabama, about 35 miles southeast of Auburn, Alabama. In February 2008, the Bank entered into a new lease agreement, which consists of approximately 600 square feet of space in the Wal-Mart. This branch offers the full line of the Bank s deposit and other services including an ATM, except safe deposit boxes.

The Bank s Hurtsboro branch was opened in June 1999. This branch is located in Hurtsboro, Alabama, about 35 miles south of Auburn, Alabama. The Bank owns this branch, which has approximately 1,000 square feet of space. The Bank leases the land for this branch from a third party. In June 2009, the Bank s land lease renewed for another year. This branch offers the full line of the Bank s services including safe deposit boxes, a drive-through window and an ATM. This branch offers parking for approximately 12 vehicles, including a handicapped ramp.

The Bank s Auburn Wal-Mart Supercenter branch was opened in September 2000 inside the Wal-Mart shopping center on the south side of Auburn, Alabama. In September 2005, 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 deposit and other services, including an ATM, except safe deposit boxes.

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 2009, the Bank s land lease renewed for another year. 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 November 2002, the Bank opened a mortgage loan office in Phenix City. The mortgage office is located in Phenix City, Alabama, about 35 miles south of Auburn, Alabama. In November 2009, the Bank renewed its lease for another year. This office only offers mortgage loan services.

Also in July 2002, the Bank s Opelika Wal-Mart Supercenter branch was opened inside the Wal-Mart shopping center in Opelika, Alabama. In July 2007, 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 September 2004, the Bank opened a mortgage loan office in Valley. The mortgage office is located in Valley, Alabama, about 30 miles northeast of Auburn, Alabama and has approximately 1,650 square feet of space. In January 2010, the Bank extended the lease agreement for another year. This office only offers mortgage loan services.

In December 2006, the Bank opened a leased mortgage loan production office in Mountain Brook, part of the Birmingham, Alabama metropolitan area. This office contains approximately 1,300 square feet of space and is located off of Highway 280. This office only offers mortgage loan services.

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. The Branch offers the full line of bank deposit and other services including an ATM, except for safe deposit boxes.

Additionally, the Company completed one purchases in 2006 and one purchase in 2007 for properties that adjoin the Bank s main office location. These properties were acquired by the Company for purposes of future expansion.

In February 2009, the Bank opened a new 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, including two handicapped spaces.

In addition, the Bank leases from the Company approximately 8,500 square feet of space in the AuburnBank Center (the Center), which is located next to the main office. This building, which has approximately 18,000 square feet of space, is also leased to outside third parties. Leases between the Bank and the Company are based on the same terms and conditions as leases to outside third parties leasing space in the same building. The Bank s data processing activities, as well as other operations, are located in this leased space. The parking lot provides parking for approximately 120 vehicles, including handicapped parking.

Directly behind the Center is an older home that is also owned by the Company. This building is rented as housing to university students. The rear portion of this property is used as a parking area for approximately 20 vehicles of Bank employees. The Bank also owns a two-story building located directly behind the main office which is currently unoccupied.

The Company owns a commercial office building (the Hudson Building) located across the street from the main office in downtown Auburn. The Hudson Building has two floors and a basement which contain approximately 14,500 square feet of leasable space. Approximately 60% of this building is rented by unaffiliated third-party tenants. The Bank occupies approximately 3,000 square feet, which includes a portion of the basement level used for storage and space used to house certain bank functions. The Bank pays rent to the Company based on current market rates for such space.

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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.

We have not incurred any penalties for failing to include on our tax returns any information required to be disclosed under Section 6011 of the Internal Revenue Code of 1988, as amended (the Code) with respect to a reportable transaction under the Code and that is required to be reported under Code Section 6707A(e).

ITEM 4. RESERVED

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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 10 2010, there were approximately 3,643,112 shares of the Company s Common Stock issued and outstanding, which were held by approximately 434 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 paid to shareholders during the indicated periods.

	Closing Price Per Share (1)		Cash Dividends Declared
	High	**Low**	
2009			
First Quarter	$ 26.40	$ 18.07	$ 0.19
Second Quarter	30.00	21.75	0.19
Third Quarter	29.99	22.50	0.19
Fourth Quarter	25.98	18.93	0.19
2008			
First Quarter	$ 24.50	$ 19.00	$ 0.185
Second Quarter	23.71	21.50	0.185
Third Quarter	25.00	22.10	0.185
Fourth Quarter	23.97	19.06	0.185

(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 Company s Board of Directors based upon a number of factors, including the Company s earnings, financial condition, capital requirements and other relevant factors. Company management currently intends to continue its present dividend policies.

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. Although Federal Reserve policy could restrict future dividends on Common Stock, such policy places no current restrictions on such dividends. See SUPERVISION AND REGULATION Payment of Dividends and MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS CAPITAL ADEQUACY.

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Performance Graph

The following performance graph and related information shall not be deemed soliciting material nor to be filed with the SEC, nor shall such information be incorporated by reference into any future filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, each as amended, except to the extent we specifically incorporate it by reference into such filing.

The following line-graph compares the cumulative, total return on the Company s Common Stock from December 31, 2004 to December 31, 2009, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a $100 investment on December 31, 2004). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.

	Period Ending					
Index	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**
Auburn National Bancorporation Inc.	100.00	110.66	148.21	115.64	109.40	110.82
Nasdaq Composite	100.00	101.37	111.03	121.92	72.49	104.31
SNL Southeast Bank	100.00	102.36	120.03	90.42	36.60	36.75

ISSUER PURCHASES OF EQUITY SECURITIES[1]

Period[1]	Total Number of Shares (or Units) Purchased[2]	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs[3]	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
October 1 October 31, 2009	1,000	$22.86	1,000	161,113
November 1 November 30, 2009				161,113
December 1 December 31, 2009				161,113
Total	1,000	$22.86	1,000	161,113

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

(2) A total of 1,000 shares were purchased in privately negotiated transactions.

(3) On April 8, 2008, the Company s Board of Directors authorized a stock repurchase program pursuant to which the Company was authorized to repurchase up to 200 thousand shares of its common stock. As of December 31, 2009, 161,113 shares may yet be purchased under the April 2008 authorization. The April 2008 authorization expired on February 28, 2010.

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 1 Selected Financial Data and general discussion of MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS , which is included in Item 7.

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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, 2009 and 2008 and our results of operations for the years ended December 31, 2009, 2008, and 2007. The purpose of this discussion is to focus on 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 Special Cautionary Notice Regarding Forward-Looking Statements.

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

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 in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, Hurtsboro and Notasulga, Alabama. In-store branches are located in the Auburn and Opelika Kroger stores, as well as Wal-Mart SuperCenter stores in Auburn, Opelika and Phenix City, Alabama. Mortgage loan offices are located in Phenix City, Valley, and Mountain Brook, Alabama.

Summary of Results of Operations

	Years ended December 31		
(Dollars in thousands, except per share amounts)	**2009**	**2008**	**2007**
Net interest income (a)	$ 20,448	$ 19,231	$ 16,728
Less: tax-equivalent adjustment	1,633	1,361	1,123
Net interest income (GAAP)	18,815	17,870	15,605
Noninterest income	3,132	4,202	5,936
Total revenue	21,947	22,072	21,541
Provision for loan losses	5,250	870	23
Noninterest expense	14,633	12,542	12,360
Income tax (benefit) expense	(340)	2,023	2,240
Net earnings	$ 2,404	$ 6,637	$ 6,918
Basic and diluted earnings per share	$ 0.66	$ 1.81	$ 1.86

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

Financial Summary

The Company s net earnings were $2.4 million, or $0.66 per share, for the full year 2009, compared to $6.6 million, or $1.81 per share, in 2008.

Total tax-equivalent net interest income increased 6% to a record $20.4 million in 2009 compared to $19.2 million in 2008, reflecting balance sheet growth. Average loans and loans held for sale increased 10% in 2009 from 2008 to $380.4 million. Average total deposits increased 15% in 2009 from 2008 to $596.4 million.

Credit quality deteriorated in 2009, when compared to 2008, due to continued economic stress and its impact on the residential real estate market. Although the Company s level of net-charge-offs and nonperforming assets compare favorably to industry peers, the Company experienced an increase in both measures during 2009. Net charge-offs as a percentage of average loans were 0.84% in 2009, compared to 0.17% in 2008. At December 31, 2009, nonperforming assets were 2.15% of total assets, compared to 0.64% as of December 31, 2008. The increase in net charge-offs and nonperforming assets was primarily due to deterioration in the Company s construction and land development loan portfolio. Continued weakness in the residential real estate market and the overall economy adversely affected the Company s volume of nonperforming assets in 2009, and these economic conditions are expected to persist for the foreseeable future. The provision for loan losses was $5.3 million in 2009, compared to $0.9 million in 2008. Increases in nonperforming loans, net-charge offs and the overall risk profile of the loan portfolio were the primary reasons for the increase in the provision expense in 2009 when compared to 2008.

Noninterest income decreased $1.1 million, or 25%, in 2009 from 2008. This decrease primarily reflects increases in other-than-temporary impairment charges related to pooled trust preferred securities and an investment in the trust preferred securities and common stock of Silverton Financial Services, Inc., offset by increases in mortgage lending income during 2009 when compared to 2008. At December 31, 2009, the remaining amortized cost of pooled trust preferred securities was $0.3 million or 6% of its original amortized cost.

Noninterest expense increased $2.1 million, or 17%, in 2009 from 2008. This increase primarily reflects increases in FDIC insurance and other regulatory assessments, despite being assessed at the FDIC s lowest rate because of the Company s well capitalized status under current regulatory guidelines. Salaries and benefits expense also contributed to the increase as commissions paid to our mortgage originators increased due to increased origination volume in 2009 when compared to 2008. No cash incentive awards were accrued for Company and Bank officers in 2009.

In 2009, the Company paid cash dividends of $2.8 million, or $0.76 per share. The Company s balance sheet remains strong and well capitalized under current regulatory guidelines with a total risk-based capital ratio of 14.98%, a tier one risk-based capital ratio of 13.73%, and a tier one leverage capital ratio of 8.13% at December 31, 2009.

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, 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 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, current asset quality trends, 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, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loan losses are charged off when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely. Allocation of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management s judgment, is deemed to be uncollectible.

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

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan (recorded investment in the loan is the principal balance plus any accrued interest, net of deferred loan fees or costs and unamortized premium or discount). 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 Company believes it follows appropriate accounting and regulatory guidance in determining impairment and accrual status of impaired loans.

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

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing independent loan review process. The Company s loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the 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 we 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 loans (including financial and agricultural loans), construction and land development loans, mortgage loans secured by commercial real estate, mortgage loans secured by residential real estate, and consumer 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.

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 maintains an unallocated amount for inherent factors that cannot be practically assigned to individual loan segments or categories. An example is the imprecision in the overall measurement process, in particular the volatility of the national and local economy.

The Company constantly re-evaluates its practices in determining the allowance for loan losses. For instance, in order to better capture the effect of current economic conditions on the Company s loan loss experience, the Company calculated average losses by loan segment using a rolling 12 quarter historical period starting from the quarter ended September 30, 2009. Prior to September 30, 2009, the Company calculated average losses using a five year historical period.

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

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

The Company assesses impairment for pooled trust preferred securities using a cash flow model. The key assumptions include default probabilities of the underlying collateral and recoveries on collateral defaults. These assumptions may have a significant effect on the determination of the present value of expected future cash flows and the resulting amount of other-than-temporary impairment. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

Fair Value Determination

GAAP requires management to value and present at fair value certain of the Company s assets and liabilities, including investments classified as available-for-sale and derivatives. FASB ASC 820, *Fair Value Measurements and Disclosures*, (SFAS No. 157, *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. For more information regarding fair value measurements and disclosures, please refer to Note 15 of the Consolidated Financial Statements.

Fair values are based on market prices when available. However, some of the Company s transactions lack an available trading market characterized by frequent transactions between a willing buyer and seller. In these cases, such values are 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, is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal realized at the time of disposal are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of other real estate owned, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility, as experienced during 2009. 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 real estate owned.

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 the we will realize the benefits of these deductible differences at December 31, 2009. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the future periods are reduced.

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Average Balance Sheet and Interest Rates

	Years ended December 31					
	2009		2008		2007	
	Average	Yield/	Average	Yield/	Average	Yield/
(Dollars in thousands)	Balance	Rate	Balance	Rate	Balance	Rate
Loans and loans held for sale	$ 380,434	5.75%	$ 347,176	6.47%	$ 304,389	7.56%
Securities - taxable	269,266	4.37%	258,160	5.11%	242,826	4.96%
Securities - tax-exempt	74,794	6.42%	62,801	6.37%	51,995	6.36%
Total securities	344,060	4.82%	320,961	5.36%	294,821	5.21%
Federal funds sold	10,138	0.23%	3,197	1.91%	5,539	4.98%
Interest bearing bank deposits	1,135	0.09%	511	2.74%	693	4.62%
Total interest-earning assets	735,767	5.23%	671,845	5.91%	605,442	6.39%
Deposits:						
NOW	90,794	0.95%	75,461	2.08%	57,532	2.26%
Savings and money market	93,484	1.13%	103,379	1.76%	143,587	3.65%
Certificates of deposits less than $100,000	147,438	2.97%	110,592	4.23%	85,831	5.33%
Certificates of deposits and other time deposits of $100,000 or more	186,484	3.67%	157,830	4.44%	133,466	4.45%
Total interest-bearing deposits	518,200	2.54%	447,262	3.37%	420,416	4.06%
Short-term borrowings	10,790	0.51%	16,604	1.95%	12,727	4.72%
Long-term debt	120,248	4.01%	123,108	4.14%	93,278	4.60%
Total interest-bearing liabilities	649,238	2.78%	586,974	3.49%	526,421	4.17%
Net interest income and margin (a)	$ 20,448	2.78%	$ 19,231	2.86%	$ 16,728	2.76%

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

RESULTS OF OPERATIONS

Net Interest Income and Margin

2009 vs. 2008 comparison

Tax-equivalent net interest income increased 6% in 2009 from 2008 due to balance sheet growth. Net interest margin decreased 8 basis points to 2.78%.

The tax-equivalent yield on total interest earning assets decreased 68 basis points in 2009 from 2008 to 5.23%. This decrease was comprised of a 72 basis point decrease in the yield on loans and loans held for sale to 5.75% and a 54 basis point decrease in the tax-equivalent yield on total securities to 4.82%.

The cost of total interest-bearing liabilities decreased 71 basis points in 2009 from 2008, to 2.78%. This decrease was comprised of an 83 basis point increase in the cost of total interest-bearing deposits to 2.54%, a 144 basis point decrease in the cost of short-term borrowings to 0.51% and a 13 basis point decrease in the cost of long-term debt to 4.01%.

2008 vs. 2007 comparison

Tax-equivalent net interest income increased 15% in 2009 from 2008 due to growth in the balance sheet and net interest margin expansion. Net interest margin increased 10 basis points to 2.86%.

The tax-equivalent yield on total interest earning assets decreased 48 basis points in 2008 from 2007 to 5.91%. This decrease was comprised of a 109 basis point decrease in the yield on loans and loans held for sale to 6.47%, which was offset by a 15 basis point increase in the tax-equivalent yield on total securities to 5.36%.

The cost of total interest-bearing liabilities decreased 68 basis points in 2008 from 2007, to 3.49%. This decrease was comprised of a 69 basis point decrease in the cost of total interest-bearing deposits to 3.37%, a 277 basis point decrease in the cost of short-term borrowings to 1.95% and a 46 basis point decrease in the cost of long-term debt to 4.14%.

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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 $5,250,000, $870,000, and $23,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

The impact of continuing economic distress, specifically its impact on the residential construction market, contributed to the significant increase in year over year provisioning expense. Increases in nonperforming loans, net-charge offs and the overall risk profile of the loan portfolio were the primary reasons for the increase in the provision expense in 2009 when compared to 2008. The increases in nonperforming assets were caused primarily by deterioration in the Company s construction and land development loan portfolio. The construction and land development loan portfolio has experienced weakness due to continued decreased real estate sales which has led to falling appraisal values of the collateral which secures the Company s construction and land development loan portfolio. The Company s collateral for construction and land development loans is generally the primary source of repayment. As the value of the collateral deteriorates, ultimate repayment by the borrower becomes increasingly difficult. As a result, the Company has increased its allowance for loan losses which has led to increased provision for loan losses in 2009 compared to 2008.

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes should be appropriate to adequately cover probable losses in the loan portfolio. The Company s allowance for loan losses increased from 1.19% at December 31, 2008 to 1.73% at December 31, 2009. 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, 2009. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management and are reviewed from time to time by our regulators, they are necessarily approximate and imprecise. There exist factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions which may negatively impact, materially, our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

Noninterest Income

	Years ended December 31		
(Dollars in thousands)	**2009**	**2008**	**2007**
Service charges on deposit accounts	$ 1,243	$ 1,252	$ 1,302
Mortgage lending	4,048	1,694	2,235
Bank-owned life insurance	424	470	547
Securities (losses) gains, net	(3,703)	(1,168)	253
Other	1,120	1,954	1,599
Total noninterest income	$ 3,132	$ 4,202	$ 5,936

The major components of noninterest income are service charges on deposit accounts, mortgage lending income, income from bank-owned life insurance, securities (losses) gains, net, and other noninterest income. The following table presents a breakdown of the Company s mortgage lending income for 2009, 2008 and 2007:

	Years ended December 31		
(Dollars in thousands)	**2009**	**2008**	**2007**

Origination income	$	3,702	$	1,375	$	1,896
Servicing fees, net		346		319		339
Total mortgage lending income	$	4,048	$	1,694	$	2,235

The Company s income from mortgage lending is primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing mortgage loans. The Company s normal practice is to originate mortgage loans for sale in the secondary market and to either release or retain the associated mortgage servicing rights (MSRs) when the loan is sold. Prior to January 1, 2009, the volume of loans sold servicing retained was not significant; therefore no servicing rights were capitalized. 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.

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2009 vs. 2008 comparison

Mortgage lending income was $4.0 million in 2009, compared to $1.7 million in 2008. Origination income, a component of mortgage lending income, 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. Significantly increased volume and better pricing during 2009 when compared to 2008 contributed to higher mortgage lending income during 2009.

The total net loss on securities was $3.7 million in 2009, compared to $1.2 million in 2008. Gross realized losses of $6.6 million in 2009 primarily related to other-than-temporary impairment charges for trust preferred securities and an investment in the common stock of Silverton Financial Services, Inc. These losses were offset by gross realized gains of $2.9 million during the same period. Gross realized losses of $1.6 million in 2008 primarily related to other-than-temporary impairment for one pooled trust preferred security. These losses were offset by gross realized gains of $0.4 million during the same period.

Other noninterest income was $1.1 million in 2009, compared to $2.0 million in 2008. The decrease is primarily due to nonrecurring items included in 2008 totals. In 2008, other noninterest income was impacted by a $1.1 million gain related to the sale of certain real property. This was offset by a $0.5 million pre-tax charge in 2008 related to the correction of an accounting error in prior periods. Information concerning the correction of an accounting error is included in Note 1 to the Consolidated Financial Statements.

2008 vs. 2007 comparison

Mortgage lending income was $1.7 million in 2008, compared to $2.2 million in 2007. Decreased origination volume during 2008 when compared to 2007 contributed to the decrease in mortgage lending income during 2008.

The Company reported a net loss on securities of $1.2 million in 2008, compared to a net gain of $0.3 million in 2007. Gross realized losses of $1.6 million in 2008 primarily related to other-than-temporary impairment for one pooled trust preferred security. These losses were offset by gross realized gains of $0.4 million during the same period. Gross realized gains of $0.9 million in 2007 were offset by $0.6 million in gross losses during the same period.

Income generated from bank-owned life insurance was $470 thousand in 2008, a decrease of 14% from 2007. 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 not taxable. As a result of downgrades related to mortgage-backed securities holdings, policy investment returns have underperformed as compared to 2007.

Other noninterest income was $2.0 million in 2008, compared to $1.6 million in 2008. The increase is primarily due to nonrecurring items included in 2008 totals. In 2008, other noninterest income was impacted by a $1.1 million gain related to the sale of certain real property. This was offset by a $0.5 million pre-tax charge in 2008 related to the correction of an accounting error in prior periods. Information concerning the correction of an accounting error is included in Note 1 to the Consolidated Financial Statements.

Noninterest Expense

	Years ended December 31		
(Dollars in thousands)	**2009**	**2008**	**2007**
Salaries and benefits	$ 7,819	$ 7,278	$ 7,110
Net occupancy and equipment	1,500	1,314	1,267
Professional fees	799	511	621
FDIC and other regulatory assessments	1,322	358	117
Loss on prepayment of FHLB advances			313
Other	3,193	3,081	2,932

Total noninterest expense	$ 14,633	$ 12,542	$ 12,360

The major components of noninterest expense are salaries and benefits, net occupancy and equipment, professional fees, FDIC and other regulatory assessments, loss on prepayment of FHLB advances, and other noninterest expense.

2009 vs. 2008 comparison

Salaries and benefits expense was $7.8 million in 2009, compared to $7.3 million in 2008. The primary driver of the increase related to increases in commissions paid to our mortgage originators as a result of increased origination volume. Increases in normal annual officer and employee salaries and wages in 2009 were offset by a reduction in the payout related to the Company s annual cash incentive awards. No cash incentive awards were accrued for Company and Bank officers in 2009.

Net occupancy and equipment expense was $1.5 million in 2009, compared to $1.3 million in 2008. The primary driver of the increase relates to start-up costs for a new branch that was opened in the first quarter of 2009 and the related increases in operating costs and depreciation expense.

Professional fees expense was $0.8 million in 2009, compared to $0.5 million in 2008. The increase primarily relates to increased costs of regulatory compliance, including Sarbanes-Oxley and other legislative and regulatory measures.

FDIC and other regulatory assessments expense was $1.3 million in 2009, compared to $0.4 million in 2008. This change was primarily a result of the significant increase in the Company s FDIC insurance assessments in 2009, despite being assessed at the FDIC s lowest rate because of the Company s status as well capitalized under federal regulations. As a result of the requirement to increase the FDIC s Bank Insurance Fund to statutory levels over a prescribed period of time and increased pressure on the fund s reserves due to the increasing number of bank failures, annual FDIC insurance costs were significantly higher for all insured depository institutions. Also, during the second quarter of 2009, a special assessment from the FDIC of approximately $0.4 million was accrued to provide additional reserves for the FDIC s bank insurance fund. The Company anticipates more bank failures through the duration of this credit cycle resulting in higher assessments for all institutions.

2008 vs. 2007 comparison

Salaries and benefits expense was $7.3 million in 2008, compared to $7.1 million in 2008. The primary driver of the increase related to normal increases in salaries and benefits costs. These increases were partially offset by a decrease in commissions paid to our mortgage originators as a result of decreased origination volume in 2008 compared to 2007.

FDIC and other regulatory assessments expense was $358 thousand in 2008, compared to $117 thousand in 2007. This change was primarily a result of the increased annual insurance costs for all institutions, and the expiration of the Bank s one-time FDIC insurance credit during the first quarter of 2008.

During 2007, the Company incurred a loss on the prepayment of Federal Home Loan Bank advances of $0.3 million in order to reposition the Company s funding sources for asset liability management purposes.

Income Tax Expense

2009 vs. 2008 comparison

In 2009, the Company recorded an income tax benefit of $0.3 million, compared to income tax expense of $2.0 million in 2008. This change was primarily due to a decrease in the level of earnings before taxes relative to tax-exempt sources of income in 2009 when compared to 2008. The effective income tax benefit rate was 16.47% in 2009, compared to an effective income tax rate of 23.36%. The decrease in the effective tax rate from 2008 to 2009 was primarily due to a 76% decrease in earnings before taxes while tax-exempt sources of income remained relatively consistent in both years. Also reflected in the Company s effective income tax benefit rate for 2009 was a change in valuation allowance of $0.5 million related to nondeductible capital losses and an income tax benefit of $0.3 million related to the correction of an accounting error in prior periods. Information concerning the correction of an accounting error is included in Note 1 to the Consolidated Financial Statements.

2008 vs. 2007 comparison

Income tax expense was $2.0 million in 2008, compared to $2.2 million in 2007. The Company s effective tax rate decreased to 23.36% in 2008, compared to 24.46% in 2007. The decrease in the Company s effective tax rate in 2008 was primarily driven by a decrease in earnings before taxes and an increase in tax-exempt interest income when compared to 2007.

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BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale were $334.8 million and $302.7 million as of December 31, 2009 and 2008, respectively. The increase from December 31, 2008 was primarily due to growth in deposit funding and decreased loan demand. Unrealized net gains on securities available-for-sale were $0.2 million as of December 31, 2009 compared to unrealized net gains of $1.0 million as of December 31, 2008. The decrease in unrealized net gains of $0.8 million from December 31, 2008 was primarily due to changes in interest rates. The average tax-equivalent yields earned on total securities were 4.82% in 2009 and 5.36% in 2008.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2009 according to contractual maturity. Actual maturities may differ from contractual maturities of mortgage-backed securities because the mortgage securities underlying the securities may be called or prepaid with or without penalty.

					December 31, 2009
	1 year	**1 to 5**	**5 to 10**	**After 10**	**Total**
(Dollars in thousands)	**or less**	**years**	**years**	**years**	**Fair Value**
Agency obligations	$		42,626	47,594	90,220
Agency RMBS			5,261	153,381	158,642
State and political subdivisions		382	16,073	65,107	81,562
Trust preferred securities				1,463	1,463
Corporate debt		2,142	733		2,875
Total available-for-sale	$	2,524	64,693	267,545	334,762
Weighted average yield:					
Agency obligations			3.27%	4.34%	3.83%
Agency RMBS			4.73%	4.48%	4.49%
State and political subdivisions		4.20%	4.16%	4.22%	4.21%
Trust preferred securities				4.54%	4.54%
Corporate debt		6.75%	6.02%		6.54%
Total available-for-sale		6.42%	3.64%	4.40%	4.27%

Loans

					December 31
(In thousands)	**2009**	**2008**	**2007**	**2006**	**2005**
Commercial, financial and agricultural	$ 53,884	$ 53,883	$ 50,797	$ 45,702	$ 44,103
Construction and land development	56,820	67,420	45,724	24,683	26,347
Real estate - mortgage:					

Commercial		156,928		132,818		120,789		109,774	113,714
Residential		97,407		102,835		93,888		92,830	87,873
Consumer installment		11,236		12,463		11,525		9,328	10,315
Total loans		376,275		369,419		322,723		282,317	282,352
Less: unearned income		(172)		(257)		(312)		(334)	(293)
Loans, net of unearned income	$	376,103	$	369,162	$	322,411	$	281,983	$ 282,059

Total loans, net of unearned income, were $376.1 million as of December 31, 2009, an increase of $6.9 million, or 2%, from $369.2 million at December 31, 2008. The increase in loans, net of unearned income, is primarily due to growth in commercial real estate mortgage loans of $24.1 million, offset by a decrease in construction and land development loans and residential real estate mortgage loans of $10.6 million and $5.4 million, respectively. The increase in commercial real estate mortgage loans primarily reflects increased owner-occupied commercial real estate loans. Owner-occupied commercial real estate is similar in many ways to the Company s commercial and industrial lending in that these loans are generally made to businesses on the basis of the cash flows of the business rather than on the valuation of the real estate.

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Four loan categories represented the majority of the loan portfolio as December 31, 2009. Commercial real estate mortgage loans represented 42%, residential real estate mortgage loans represented 26%, construction and land development loans represented 15% and commercial, financial and agricultural loans represented 14% of the Company s total loans at December 31, 2009. Owner-occupied commercial real estate mortgage loans were approximately 26% of the Company s total loan portfolio at December 31, 2009.

Within the residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately $25.9 million, or 7%, and $27.9 million, or 8%, of total loans, net of unearned income at December 31, 2009 and 2008, respectively. For residential real estate mortgage loans with a consumer purpose, approximately $5.8 million and $6.1 million required interest only payments at December 31, 2009 and 2008, 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 $9.4 million and $10.7 million as of December 31, 2009 and December 31, 2008, respectively. All purchased loan participations are underwritten by the Company and independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company s normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures as described in CRITICAL ACCOUNTING POLICIES.

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

We attempt to reduce these economic and credit risks by adherence to loan to value guidelines for collateralized loans, by investigating the creditworthiness of the borrower and by monitoring the borrower s financial position. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit our exposure by prohibiting loan relationships that exceed 10% of the capital accounts of the bank if such loans are not secured or 20% of the capital accounts if loans in excess of 10% are fully secured, which would approximate $13.0 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of $11.7 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists to any one or more industries. We use broadly accepted industry classification systems in order to classify borrowers into various industry classifications. Loan concentrations to borrowers in the following industries exceeded 25% of the Bank s total risk-based capital at December 31, 2009 and 2008.

		December 31,	
(In thousands)		**2009**	**2008**
Lessors of 1-4 family residential properties	$	34,961	25,966
Office buildings:			
Owner occupied		15,740	16,631
Non-owner occupied		5,382	2,492
Total office buildings		21,122	19,123
Hotel/Motel[1] (all owner-occupied)	$	17,114	11,090

[1] Loan concentration did not exceed 25% of total risk-based capital as of December 31, 2008.

The average yield earned on loans and loans held for sale was 5.75% in 2009 and 6.47% in the 2008.

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level that management deems appropriate to adequately cover the Company s estimate of probable losses in the loan portfolio. As of December 31, 2009 and 2008, respectively, the allowance for loan losses was $6.5 million and $4.4 million, respectively, which management deemed to be adequate at

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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, 2009 is presented below.

	Year ended December 31				
(Dollars in thousands)	**2009**	**2008**	**2007**	**2006**	**2005**
Allowance for loan losses:					
Balance at beginning of period	$ 4,398	4,105	4,044	3,843	3,456
Charge-offs:					
Commercial, financial and agricutural	(495)	(454)	(62)	(37)	(38)
Construction and land development	(2,088)				
Commercial real estate - mortgage					(124)
Residential real estate - mortgage	(704)	(153)	(143)	(106)	(1)
Consumer installment	(61)	(98)	(45)	(46)	(193)
Total charge-offs	(3,348)	(705)	(250)	(189)	(356)
Recoveries:					
Commercial, financial and agricutural	47	102	14	13	94
Construction and land development	50				
Commercial real estate - mortgage			69	7	92
Residential real estate - mortgage	92	6	199	4	3
Consumer installment	6	20	6	36	69
Total recoveries	195	128	288	60	258
Net (charge-offs) recoveries	(3,153)	(577)	38	(129)	(98)
Provision for loan losses	5,250	870	23	330	485
Ending balance	$ 6,495	4,398	4,105	4,044	3,843
as a % of loans	1.73 %	1.19	1.27	1.43	1.36
as a % of nonperforming loans	69 %	99	918	5,617	3,558
Net charge-offs as a % of average loans	0.84 %	0.17	(0.01)	0.05	0.13

As noted in the Company s 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 1.73% at December 31, 2009, compared to 1.19% at December 31, 2008. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken. At December 31, 2009, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 69%, compared to 99% at December 31, 2008. The decrease in this ratio was primarily due to an increase in nonperforming loans that the Company believes are well-collateralized based on current appraisals and other comparable sales data.

At December 31, 2009, the Company s recorded investment in loans considered impaired was $9.7 million, with a corresponding valuation allowance (included in the allowance for loan losses) of $1.3 million. At December 31, 2008, the Company s recorded investment in loans considered impaired was $4.3 million, with no corresponding valuation allowance. No valuation allowance was established for impaired loans at December 31, 2008 because the fair value of the collateral less estimated selling costs was greater than the Company s recorded investment in the impaired loans.

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

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Nonperforming Assets

At December 31, 2009 the Company had $16.6 million in nonperforming assets compared to $4.8 million at December 31, 2008. Included in nonperforming assets were nonperforming loans of $9.4 million and $4.4 million at December 31, 2009 and 2008, respectively. The increase in nonperforming asset balances during the year ended December 31, 2009 is primarily related to deterioration of the construction and land development loan portfolio due to weakened residential real estate market conditions.

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

						December 31
(In thousands)		2009	2008	2007	2006	2005
Nonperforming assets:						
Nonaccrual loans	$	9,352	4,431	447	72	108
Other nonperforming assets (primarily other real estate owned)		7,292	324	98		
Total nonperforming assets	$	16,644	4,755	545	72	108
as a % of loans and foreclosed properties		4.34 %	1.29	0.17	0.03	0.04
as a % of total assets		2.15 %	0.64	0.08	0.01	0.02
Noperforming loans as a % of total loans		2.49 %	1.20	0.14	0.03	0.04
Accruing loans 90 days or more past due	$	5	104	4		

The Lee County Association of Realtors (LCAR) of Alabama reported that the average median residential home price in Lee County for the quarter ended December 31, 2009 was $162,774 thousand, a decrease of 6.9% from the same quarter a year earlier. LCAR also reported that residential inventory at December 31, 2009 was 1,127 homes, a decrease of 2.3% from a year earlier. The average number of days on the market for the quarter ended December 31, 2009 was 166 days, a decrease of 2.9% from the same quarter last year. Continued weakness in the residential real estate market and the overall economy could adversely affect the Company s volume of nonperforming assets.

The table below provides information concerning the composition of nonaccrual loans at December 31, 2009 and 2008, respectively.

		December 31,	
(In thousands)		2009	2008
Nonaccrual loans:			
Construction and land development	$	7,542	4,329
Real estate - mortgage:			
Commercial		961	
Residential		842	98
Consumer installment		7	4
Total nonaccrual loans / nonperfoming loans	$	9,352	4,431

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, 2009, the Company had $9.4 million in loans on nonaccrual, compared to $4.4 million at December 31, 2008. Approximately $6.9 million of total nonaccrual loans at December 31, 2009 related to two construction and land development loans. One loan is secured by a completed residential condominium project located in the Company s primary markets. The other loan is a purchased participation secured by partially developed land located near the Florida Gulf Coast. Of the remaining balance in nonaccrual loans at December 31, 2009, the average individual loan balance was approximately $197,000.

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 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, 2009 and 2008, respectively, the Company had no accruing restructured loans.

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The Company had $5 thousand and $104 thousand in loans 90 days past due and still accruing interest at December 31, 2009 and 2008, respectively.

The table below provides information concerning the composition of other real estate owned at December 31, 2009 and 2008, respectively.

(In thousands)		December 31, 2009	2008
Other real estate owned:			
Residential condo development	$	4,329	
New home construction		490	211
Developed lots		136	
Undeveloped land		2,210	
Other		127	113
Total other real estate owned	$	7,292	324

The Company owned $7.3 million in other real estate, which we had acquired from borrowers at December 31, 2009, compared to $0.3 million at December 31, 2008. The increase in other real estate owned primarily relates to two properties with a total carrying value of $6.5 million at December 31, 2009. The first property is undeveloped land located near the Company s primary markets. The second property is a completed condominium project on the Florida Gulf Coast. The Company had previously purchased a participation interest in the first lien mortgage loan on this property from Silverton Bank. Subsequently, this loan defaulted and was foreclosed upon and the Company s interest in the property is currently included in other real estate owned. Following Silverton Bank s failure on May 1, 2009, the FDIC has held this property as the receiver of Silverton Bank. CB Richard Ellis, a national real estate firm, has been managing this property and selling condominiums in the project as a FDIC contractor. The Company depends upon the FDIC and CB Richard Ellis for information regarding this property and its performance. Based upon the latest information available to us, including appraisals, current unit sales, and comparable sales, we believe that the fair value of the Company s interest in these properties, less selling costs, exceeds the Company s recorded investment.

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. Potential problem loans, which are not included in nonperforming assets, amounted to $16.8 million, or 4.5% of total loans outstanding, net of unearned income at December 31, 2009, compared to $3.9 million, or 1.1% of total loans outstanding, net of unearned income at December 31, 2008. The large increase in potential problem loans was caused by the downgrade of loans across all categories, but the majority of the increase relates to loans secured by residential and commercial real estate. Continued weakness in the residential real estate market and the overall economy has adversely affected the Company s volume of potential problem loans, and these economic conditions are expected to persist for the foreseeable future.

The table below provides information concerning the composition of potential problem loans at December 31, 2009 and 2008, respectively.

(In thousands)		December 31, 2009	2008
Potential problem loans:			
Commercial, financial, and agricultural	$	1,771	795
Construction and land development		1,682	55
Real estate - mortgage:			
Commercial		5,659	177
Residential		7,502	2,853
Consumer installment		198	73

Total potential problem loans	$	16,812	3,953

At December 31, 2009, the average individual loan balance of loans classified as potential problem loans was $141 thousand. At December 31, 2009, approximately $2.3 million or 13.5% of total potential problem loans were past due at least 30 but less than 90 days.

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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, 2009 and 2008, respectively.

(In thousands)		December 31, 2009	2008
Performing loans past due 30 to 90 days:			
Commercial, financial, and agricultural	$	339	510
Construction and land development		137	14
Real estate - mortgage:			
Commercial		1,048	
Residential		1,626	1,300
Consumer installment		46	87
Total performing loans past due 30 to 90 days	$	3,196	1,911

Deposits

(Dollars in thousands)		December 31 2009	2008
Non-interest bearing demand	$	76,497	78,013
NOW		84,297	82,945
Money market		82,433	67,322
Savings		21,302	19,304
Certificates of deposit under $100,0000		114,399	102,731
Certificates of deposit and other time deposits of $100,000 or more		200,481	200,528
Total deposits	$	579,409	550,843

Total deposits were $579.4 million and $550.8 million at December 31, 2009 and 2008, respectively. The increase of $28.6 million in total deposits from December 31, 2008 was largely due to increases of $15.1 million and $11.7 million, respectively, in money market accounts and certificates of deposit (CDs) less than $100,000. The increase in money market accounts primarily relates to increases in public depositor account balances and the increase in CDs less than $100,000 reflects increases in new customer accounts during 2009.

The average rates paid on total interest-bearing deposits were 2.54% in 2009 and 3.37% in 2008. Noninterest bearing deposits were 13% and 14% of total deposits as of December 31, 2009 and 2008, respectively.

Other Borrowings

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased, securities sold under agreements to repurchase, and other short-term borrowings. The Bank had available federal fund lines totaling $34.0 million with $12.5 million outstanding at December 31, 2009, compared to $46.0 million with none outstanding at December 31, 2008. The decrease in federal funds lines is primarily due to the discontinuance of a $16.0 million federal funds line provided by Silverton Bank, which failed on May 1, 2009. The Company has reviewed all available sources of liquidity and believes the current level of available federal funds lines is sufficient. Securities sold under agreements to repurchase totaled $3.5 million at December 31, 2009, compared to 10.9 million at December 31, 2008. The decrease in securities sold under agreements to repurchase reflects decreases in interest rates and related shifts as customers sought more yield in a low interest rate environment.

The average rates paid on short-term borrowings were 0.51% in 2009 and 1.95% in 2008. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the three-year period ended December 31, 2009 is included in Note 8 to the Consolidated Financial Statements.

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

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securities outstanding at December 31, 2009 and 2008, respectively.

The average rates paid on long-term debt were 4.01% in 2009 and 4.14% in 2008.

CAPITAL ADEQUACY

The Company s consolidated stockholders equity was $56.2 million and $57.1 million as of December 31, 2009 and 2008, respectively. The decrease from December 31, 2008 was primarily a result of cash dividends of $2.8 million and an other comprehensive loss of $0.5 million due to changes in unrealized gains (losses) on securities available-for-sale, net. This decrease was offset by net earnings of $2.4 million.

The Company s Tier 1 leverage ratio was 8.13%, Tier 1 risk-based capital ratio was 13.73% and Total risk-based capital ratio was 14.98% at December 31, 2009. These ratios exceed the minimum regulatory capital percentages of 4.0% for Tier 1 leverage ratio, 4.0% for Tier 1 risk-based capital ratio and 8.0% for Total risk-based capital ratio. Based on current regulatory standards, the Company is classified as well capitalized.

MARKET AND LIQUIDITY RISK MANAGEMENT

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

Interest Rate Sensitivity Management

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates. ALCO measures and evaluates 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.

The dollar difference between rate sensitive assets and liabilities for a given period of time is referred to as the rate sensitive gap (GAP). A GAP ratio is calculated by dividing rate sensitive assets by rate sensitive liabilities. Due to the nature of the Bank s balance sheet structure and our market approach to pricing our liabilities, management and the Board of Directors recognize that achieving a perfectly matched GAP position in any given time frame would be extremely rare. ALCO has determined that an acceptable level of interest rate risk would be for net interest income to fluctuate no more than 10.0% given a change in selected interest rates of up or down 200 basis points over any 12-month period. Using an increase of 200 basis points and a decrease of 200 basis points, at December 31, 2009, the Bank s net interest income would decrease approximately 4.53% in a falling rate environment and would increase approximately 0.22% in a rising rate environment. Interest rate scenario models are prepared using software created and licensed by a third party.

For purposes of measuring interest rate sensitivity, Company management provides growth assumptions to incorporate over the 12-month period. Although demand and savings accounts are subject to immediate withdrawal, all passbook savings and regular NOW accounts are reflected in the model as repricing based on industry data from a third party. For repricing GAP, these accounts are repricing immediately.

Certificates of deposit are spread according to their contractual maturity. Investment securities and loans reflect either the contractual maturity, call date, repricing date or in the case of mortgage-related products, a market prepayment assumption.

The interest sensitive assets at December 31, 2009 that reprice or mature within 12 months were $298.1 million, while the interest sensitive liabilities that reprice or mature within the same time frame were $420.5 million. At December 31, 2009, the 12 month cumulative GAP position was a negative $122.4 million, resulting in a GAP ratio of interest sensitive assets to interest sensitive liabilities of 71%. This negative GAP indicates that the Company has more interest-bearing liabilities than interest-earning assets that reprice within the GAP period. For additional information, see Table 11 Sensitivities to Changes in Interest Rates. ALCO realizes that GAP is limited in scope since it does not capture all the options of repricing opportunities in the balance sheet. Therefore, ALCO places its emphasis on income at risk and economic value of equity measurements.

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, 2009 and 2008, the Company had not entered into any derivative contracts to assist in managing our interest rate sensitivity.

The Company manages the relationship of interest sensitive assets to interest sensitive liabilities and the resulting effect on net interest income. The Company utilizes a simulation model to analyze net interest income sensitivity to movements in interest rates. The simulation model projects net interest income based on both a rise and fall in interest rates of 200 basis points over a 12-month period. The model is based on actual repricing dates of interest sensitive assets and interest sensitive liabilities. The model incorporates assumptions regarding the impact of changing interest rates on the prepayment rates of certain assets. The assumptions are based on nationally published prepayment speeds on given assets when interest rates increase or decrease by 200 basis points or more.

Interest rate risk represents the sensitivity of earnings to changes in interest rates. As interest rates change, the interest income and interest expense associated with the Company s interest sensitive assets and liabilities also change, thereby affecting net interest income, the primary component of the Company s earnings. ALCO utilizes the results of the simulation model and the Economic Value of Equity report to quantify the estimated exposure of net interest income to a sustained change in interest rates.

Currently, the Company s income exposure to changes in interest rates is relatively low. The Company measures this exposure based on a gradual increase or decrease in interest rates of 200 basis points. Given this scenario, the Company had, at year-end, a greater exposure to falling rates, as interest rates on interest-bearing liabilities are essentially floored. However, management has utilized interest rate floors as loans re-price in order to lock in the current spread between interest-bearing assets and interest-bearing liabilities. Despite this exposure to falling rates, the Company believes it is more-likely-than-not that interest rates will increase during the next twelve months.

The following chart reflects the Company s sensitivity to changes in interest rates as of December 31, 2009. Numbers are based on the December balance sheet and assume paydowns and maturities of both assets and liabilities are reinvested based on growth assumptions provided by the Company. The same growth and interest rate assumptions are used in the base, up 200 basis points, and down 200 basis points scenarios.

INTEREST RATE RISK

Income Sensitivity Summary

Interest Rate Scenario

(Dollars in thousands)

	-200 BP	**Base**	**+200 BP**
Year 1 Net Interest Income	$19,112	$20,019	$20,063
$ Change Net Interest Income	(907)	--	44
% Change Net Interest Income	(4.53)%	--	0.22%

Policy Limit: 10% for +/- 200 Basis Points (BP) over 12 months.

The preceding sensitivity analysis is a modeling analysis, which changes quarterly and consists of hypothetical estimates based upon numerous assumptions, including the interest rate levels, shape of the yield curve, prepayments on loans and securities, rates on loans and deposits, reinvestments of paydowns and maturities of loans, investments and deposits, and others. While assumptions are developed based on the current economic and market conditions, management cannot make any assurances as to the predictive nature of these assumptions, including how these estimates may be affected by customer preferences, competitors, or competitive conditions.

As market conditions vary from those assumed in the sensitivity analysis, actual results will differ. Also, the sensitivity analysis does not reflect actions that ALCO might take in responding to or anticipating changes in interest rates, or market and competitive conditions. See Table 11 Sensitivities to Changes in Interest Rates.

Liquidity Risk Management

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

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

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

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, 2009, the Bank had an available line of credit with the FHLB totaling $230.8 million, with $86.1 million outstanding. As of December 31, 2009, the Bank also had $34.0 million of federal funds lines, with $12.5 million 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, 2009, which by their terms have contractual maturity and termination dates subsequent to December 31, 2009:

	Payments due by period				
(Dollars in thousands)	**Total**	**1 year or less**	**1 to 3 years**	**3 to 5 years**	**More than 5 years**
Contractual obligations:					
Deposit maturities (1)	$ 579,409	457,335	63,946	42,375	15,753
Long-term debt	118,349	15,018	33,036	25,036	45,259
Operating lease obligations	404	179	198	27	
Total	$ 698,162	472,532	97,180	67,438	61,012

(1) Deposits with no stated maturity (demand, NOW, money market, and savings deposits) are presented in the less than one year category.

Management believes the Company s and the Bank s sources of liquidity are adequate to meet loan demand, operating needs, and deposit withdrawal requirements.

Off-Balance Sheet Arrangements

At December 31, 2009, the Bank had outstanding standby letters of credit of $8.1 million and unfunded loan commitments outstanding of $46.5 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.

Effects of Inflation and Changing Prices

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with U.S. generally accepted accounting principles and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution s performance than the effects of general levels of inflation.

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CURRENT ACCOUNTING DEVELOPMENTS

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

- Accounting Standards Update (ASU) 2009-16, *Accounting for Transfers of Financial Assets* (SFAS No. 166, *Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140*); and

- ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*); and

- ASU 2010-6, *Improving Disclosures about Fair Value Measurements*.

Information about these pronouncements is described in more detail below.

ASU 2009-16, *Accounting for Transfers of Financial Assets* (SFAS No. 166, *Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140),* modifies certain guidance contained in FASB ASC 860, *Transfers and Servicing*. This standard eliminates the concept of qualifying special purpose entities (QSPEs) and provides additional criteria transferors must use to evaluate transfers of financial assets. To determine if a transfer is to be accounted for as a sale, the transferor must assess whether it and all of the entities included in its consolidated financial statements have surrendered control of the assets. A transferor must consider all arrangements or agreements made or contemplated at the time of transfer before reaching a conclusion on whether control has been relinquished. SFAS No. 166 addresses situations in which a portion of a financial asset is transferred. In such instances the transfer can only be accounted for as a sale when the transferred portion is considered to be a participating interest. SFAS No. 166 also requires that any assets or liabilities retained from a transfer accounted for as a sale be initially recognized at fair value. This standard is effective for the Company as of January 1, 2010, with adoption applied prospectively for transfers that occur on and after the effective date. Adoption of this standard is not expected to have a significant impact on the consolidated financial statements of the Company, given the Company s current involvement in financial asset transfer activities.

ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*), amends several key consolidation provisions related to variable interest entities (VIEs), which are included in FASB ASC 810, *Consolidation*. First, the scope of FAS 167 includes entities that are currently designated as QSPEs. Second, FAS 167 changes the approach companies use to identify the VIEs for which they are deemed to be the primary beneficiary and are required to consolidate. Under existing rules, the primary beneficiary is the entity that absorbs the majority of a VIE s losses and receives the majority of the VIE s returns. The guidance in FAS 167 identifies a VIE s primary beneficiary as the entity that has the power to direct the VIE s significant activities, and has an obligation to absorb losses or the right to receive benefits that could be potentially significant to the VIE. Third, FAS 167 requires companies to continually reassess whether they are the primary beneficiary of a VIE. Existing rules only require companies to reconsider primary beneficiary conclusions when certain triggering events have occurred. SFAS No. 167 is effective for the Company as of January 1, 2010, and applies to all current QSPEs and VIEs, and VIEs created after the effective date. Adoption of this standard is not expected to have a significant impact on the consolidated financial statements of the Company.

ASU 2010-6, *Improving Disclosures about Fair Value Measurements,* changes the disclosure requirements for fair value measurements. This Update requires Companies to disclose significant transfers in and out of Level 1 and 2 of the fair value hierarchy, whereas existing rules only require the disclosure of transfers in and out of Level 3. Additionally, in the rollforward of Level 3 activity, the Update requires the presentation of information on purchases, sales, issuances and settlements on a gross basis, whereas existing rules only require presentation on a net basis for these activities. The Update also clarifies that fair value measurement disclosures should be presented for each class of assets and liabilities. A class is typically a subset of a line item in the statement of financial position. The Update requires additional information about the valuation techniques used and inputs used to measure fair value both for recurring and nonrecurring instruments classified as either Level 2 or Level 3. ASU 2010-6 is effective for the Company in the first quarter of 2010 with prospective application, except for the new requirement related to the Level 3 rollforward. Gross presentation in the Level 3 rollforward is effective for the Company in the first quarter of 2011 with prospective application. The Company s adoption of the Update will not affect the Company s consolidated financial results since it amends only the disclosure requirements for fair value measurements.

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Table 1 Explanation of Non-GAAP Financial Measures

In addition to results presented in accordance with U.S. generally accepted accounting principles (GAAP), this 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 are presented below.

				2009				2008
	Fourth	Third	Second	First	Fourth	Third	Second	First
(in thousands)	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter
Net interest income (GAAP)	$ 5,109	4,662	4,519	4,525	4,484	4,593	4,472	4,321
Tax-equivalent adjustment	438	432	404	359	353	346	341	321
Net interest income (Tax-equivalent)	$ 5,547	5,094	4,923	4,884	4,837	4,939	4,813	4,642

				Years ended December 31	
(In thousands)	2009	2008	2007	2006	2005
Net interest income (GAAP)	$ 18,815	17,870	15,605	14,923	14,882
Tax-equivalent adjustment	1,633	1,361	1,123	1,033	956
Net interest income (Tax-equivalent)	$ 20,448	19,231	16,728	15,956	15,838

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Table 2 - Selected Financial Data

(Dollars in thousands, except per share amounts)		2009	2008	2007	Years ended December 31 2006	2005
Income statement						
Tax-equivalent interest income (a)	$	38,467	39,722	38,670	35,601	31,159
Total interest expense		18,019	20,491	21,942	19,645	15,321
Tax equivalent net interest income (a)		20,448	19,231	16,728	15,956	15,838
Provision for loan losses		5,250	870	23	330	485
Total noninterest income		3,132	4,202	5,936	5,505	5,430
Total noninterest expense		14,633	12,542	12,360	11,201	11,148
Net earnings before income taxes and tax-equivalent adjustment		3,697	10,021	10,281	9,930	9,635
Tax-equivalent adjustment		1,633	1,361	1,123	1,033	956
Income tax (benefit) expense		(340)	2,023	2,240	2,312	2,209
Net earnings	$	2,404	6,637	6,918	6,585	6,470
Per share data:						
Basic and diluted net earnings	$	0.66	1.81	1.86	1.74	1.69
Cash dividends declared	$	0.76	0.74	0.70	0.64	0.58
Weighted average shares outstanding						
Basic		3,644,691	3,674,384	3,716,427	3,777,721	3,830,002
Diluted		3,644,691	3,674,384	3,716,427	3,778,055	3,830,794
Shares outstanding		3,643,117	3,646,947	3,681,809	3,743,787	3,795,016
Book value	$	15.42	15.66	14.40	12.93	11.58
Common stock price						
High	$	30.00	25.00	30.00	28.89	24.50
Low		18.07	19.00	21.30	21.50	20.00
Period-end	$	19.69	20.10	21.95	28.89	22.14
To earnings ratio		29.39x	11.10	11.80	16.60	13.10
To book value		128%	128	152	223	191
Performance ratios:						
Return on average equity		4.23%	12.18	13.50	14.66	14.26
Return on average assets		0.31%	0.92	1.06	1.06	1.08
Dividend payout ratio		115.15%	40.88	37.63	36.78	34.32
Average equity to average assets		7.21%	7.59	7.88	7.20	7.56
Asset Quality:						
Allowance for loan losses as a % of:						
Loans		1.73%	1.19	1.27	1.43	1.36
Nonperforming loans		69%	99	918	5,617	3,558
Nonperforming assets as a % of:						
Loans and foreclosed properties		4.34%	1.29	0.17	0.03	0.04
Total assets		2.15%	0.64	0.08	0.01	0.02
Nonperforming loans as % of loans		2.49%	1.20	0.14	0.03	0.04
Net charge-offs (recoveries) as a % of average loans		0.84%	0.17	(0.01)	0.05	0.13
Capital Adequacy:						
Tier 1 risk-based capital ratio		13.73%	14.23	15.09	15.59	15.73
Total risk-based capital ratio		14.98%	15.22	16.12	16.68	16.83
Tier 1 Leverage ratio		8.13%	8.75	9.02	9.22	9.10
Other financial data:						

Net interest margin (a)	2.78%	2.86	2.76	2.73	2.80
Effective income tax (benefit) expense rate	(16.47)%	23.36	24.46	25.99	25.45
Efficiency ratio (b)	62.06%	53.52	54.54	52.19	52.42
Selected period end balances:					
Securities	$ 334,762	302,656	318,373	301,937	274,961
Loans, net of unearned income	376,103	369,162	322,411	281,983	282,059
Allowance for loan losses	6,495	4,398	4,105	4,044	3,843
Total assets	773,382	745,970	688,659	635,126	608,154
Total deposits	579,409	550,843	492,585	469,648	454,995
Long-term debt	118,349	123,368	115,386	90,404	105,422
Total stockholders equity	56,183	57,128	53,018	48,418	43,954

(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.

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Table 3 - Selected Quarterly Financial Data

(Dollars in thousands, except per share amounts)					**2009**				**2008**
		Fourth	**Third**	**Second**	**First**	**Fourth**	**Third**	**Second**	**First**
Income statement									
Tax-equivalent interest income (a)	$	9,570	9,610	9,652	9,635	9,839	9,895	9,928	10,060
Total interest expense		4,023	4,516	4,729	4,751	5,002	4,956	5,115	5,418
Tax equivalent net interest income (a)		5,547	5,094	4,923	4,884	4,837	4,939	4,813	4,642
Provision for loan losses		2,900	1,100	700	550	250	380	180	60
Total noninterest income (loss)		799	1,159	1,263	(89)	(224)	1,737	1,316	1,373
Total noninterest expense		3,735	3,421	3,924	3,553	2,992	3,296	3,105	3,149
Net earnings before income taxes and tax-equivalent adjustment		(289)	1,732	1,562	692	1,371	3,000	2,844	2,806
Tax-equivalent adjustment		438	432	404	359	353	346	341	321
Income tax (benefit) expense		(930)	277	226	87	71	682	636	634
Net earnings	$	203	1,023	932	246	947	1,972	1,867	1,851
Per share data:									
Basic and diluted net earnings	$	0.06	0.28	0.26	0.07	0.26	0.54	0.51	0.50
Cash dividends declared	$	0.19	0.190	0.190	0.190	0.185	0.185	0.185	0.185
Weighted average shares outstanding									
Basic and diluted		3,643,395	3,644,097	3,644,491	3,646,827	3,658,193	3,677,509	3,680,144	3,681,809
Shares outstanding		3,643,117	3,644,097	3,644,097	3,644,957	3,646,947	3,676,836	3,677,823	3,681,809
Book value	$	15.42	16.03	14.53	15.14	15.66	14.09	14.51	15.29
Common stock price									
High	$	25.98	29.99	30.00	26.40	23.97	25.00	23.71	24.50
Low		18.93	22.50	21.75	18.07	19.06	22.10	21.50	19.00
Period-end	$	19.69	24.40	28.50	21.00	20.10	24.00	22.10	22.00
To earnings ratio		29.39x	28.05	25.22	15.22	11.10	11.82	11.28	11.52
To book value		128%	152	196	139	128	170	152	144
Performance ratios:									
Return on average equity		1.37%	7.64	6.63	1.70	7.25	14.42	13.09	13.74
Return on average assets		0.10%	0.52	0.46	0.13	0.52	1.09	1.02	1.06
Dividend payout ratio		316.67%	67.86	73.08	271.43	71.15	34.26	36.27	37.00
Average equity to average assets		7.63%	6.78	7.00	7.45	7.18	7.58	7.79	7.71
Asset Quality:									
Allowance for loan losses as a % of:									
Loans		1.73%	1.42	1.24	1.21	1.19	1.19	1.17	1.23
Nonperforming loans		69%	64	720	100	99	90	82	88
Nonperforming assets as a % of :									
Loans and foreclosed properties		4.34%	3.52	1.53	1.24	1.29	1.50	1.55	1.52
Total assets		2.15%	1.75	0.72	0.58	0.64	0.72	0.73	0.69
Nonperforming loans as % of loans		2.49%	2.20	0.17	1.21	1.20	1.33	1.43	1.40
Net charge-offs (recoveries) as % of average loans		1.95%	0.31	0.63	0.45	0.09	0.23	0.24	0.11
Capital Adequacy:									
Tier 1 risk-based capital ratio		13.73%	13.70	13.81	13.77	14.23	14.54	14.59	14.64
Total risk-based capital ratio		14.98%	14.88	14.82	14.75	15.22	15.50	15.53	15.60

Tier 1 Leverage ratio		8.13%	8.05	7.89	8.10	8.75	8.87	8.67	8.82
Other financial data:									
Net interest margin (a)		3.02%	2.74	2.64	2.72	2.84	2.91	2.85	2.85
Effective income tax rate		NM%	21.31	19.52	26.13	6.97	25.70	25.41	25.51
Efficiency ratio (b)		58.86%	54.71	63.43	74.10	64.86	49.37	50.66	52.35
Selected period end balances:									
Securities	$	334,762	338,924	349,472	358,425	302,656	316,148	323,706	322,843
Loans, net of unearned income		376,103	385,448	373,221	374,185	369,162	354,908	345,308	331,083
Allowance for loan losses		6,495	5,458	4,646	4,532	4,398	4,226	4,049	4,074
Total assets		773,382	786,042	800,910	802,450	745,970	734,989	731,306	728,906
Total deposits		579,409	597,591	616,442	609,206	550,843	525,353	540,492	537,443
Long-term debt		118,349	118,355	118,358	123,363	123,368	128,372	123,377	123,381
Total stockholders equity		56,183	58,405	52,948	55,180	57,128	51,810	53,352	56,292

(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.
NM - not meaningful

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Table 4 - Average Balance and Net Interest Income Analysis

	Years ended December 31												
	2009					2008					2007		
(Dollars in thousands)		Average Balance		Interest Income/ Expense	Yield/ Rate		Average Balance		Interest Income/ Expense	Yield/ Rate		Average Balance		Interest Income/ Expense	Yield/ Rate
Interest-earning assets:															
Loans and loans held for sale (1)	$	380,434	$	21,864	5.75%	$	347,176	$	22,447	6.47%	$	304,389	$	23,016	7.56%
Securities - taxable		269,266		11,775	4.37%		258,160		13,199	5.11%		242,826		12,038	4.96%
Securities - tax-exempt (2)		74,794		4,804	6.42%		62,801		4,001	6.37%		51,995		3,308	6.36%
Total securities		344,060		16,579	4.82%		320,961		17,200	5.36%		294,821		15,346	5.21%
Federal funds sold		10,138		23	0.23%		3,197		61	1.91%		5,539		276	4.98%
Interest bearing bank deposits		1,135		1	0.09%		511		14	2.74%		693		32	4.62%
Total interest-earning assets		735,767		38,467	5.23%		671,845		39,722	5.91%		605,442		38,670	6.39%
Cash and due from banks		14,172					13,132					13,063			
Other assets		37,930					33,100					31,903			
Total assets	$	787,869				$	718,077				$	650,408			
Interest-bearing liabilities:															
Deposits:															
NOW	$	90,794		859	0.95%	$	75,461		1,569	2.08%	$	57,532		1,301	2.26%
Savings and money market		93,484		1,054	1.13%		103,379		1,819	1.76%		143,587		5,243	3.65%
Certificates of deposits less than $100,000		147,438		4,377	2.97%		110,592		4,676	4.23%		85,831		4,575	5.33%
Certificates of deposits and other time deposits of $100,000 or more		186,484		6,849	3.67%		157,830		7,011	4.44%		133,466		5,933	4.45%
Total interest-bearing deposits		518,200		13,139	2.54%		447,262		15,075	3.37%		420,416		17,052	4.06%
Short-term borrowings		10,790		55	0.51%		16,604		324	1.95%		12,727		601	4.72%
Long-term debt		120,248		4,825	4.01%		123,108		5,092	4.14%		93,278		4,289	4.60%
Total interest-bearing liabilities		649,238		18,019	2.78%		586,974		20,491	3.49%		526,421		21,942	4.17%
Noninterest-bearing deposits		78,244					72,914					71,201			
Other liabilities		3,580					3,715					1,544			
Stockholders equity		56,807					54,474					51,242			
Total liabilities and stockholders equity	$	787,869				$	718,077				$	650,408			
Net interest income and margin			$	20,448	2.78%			$	19,231	2.86%			$	16,728	2.76%

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

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

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Table 5 - Volume and Rate Variance Analysis

	Years ended December 31, 2009 vs. 2008			Years ended December 31, 2008 vs. 2007		
	Net	Due to change in		Net	Due to change in	
(Dollars in thousands)	Change	Rate (2)	Volume (2)	Change	Rate (2)	Volume (2)
Interest Income:						
Loans and loans held for sale	$ (583)	(2,494)	1,911	$ (569)	(3,335)	2,766
Securities - taxable	(1,424)	(1,910)	486	1,161	377	784
Securities - tax-exempt (1)	803	33	770	693	5	688
Total securities	(621)	(1,877)	1,256	1,854	382	1,472
Federal funds sold	(38)	(54)	16	(215)	(170)	(45)
Interest bearing bank deposits	(13)	(14)	1	(18)	(13)	(5)
Total interest income	$ (1,255)	(4,439)	3,184	$ 1,052	(3,136)	4,188
Interest expense:						
Deposits:						
NOW	$ (710)	(855)	145	$ 268	(105)	373
Savings and money market	(765)	(654)	(111)	(3,424)	(2,717)	(707)
Certificates of deposits less than $100,000	(299)	(1,393)	1,094	101	(946)	1,047
Certificates of deposits and other time deposits of $100,000 or more	(162)	(1,214)	1,052	1,078	(4)	1,082
Total interest-bearing deposits	(1,936)	(4,116)	2,180	(1,977)	(3,772)	1,795
Short-term borrowings	(269)	(240)	(29)	(277)	(353)	76
Long-term debt	(267)	(153)	(114)	803	(431)	1,234
Total interest expense	(2,472)	(4,509)	2,037	(1,451)	(4,556)	3,105
Net interest income	$ 1,217	70	1,147	$ 2,503	1,420	1,083

(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.

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Table 6 - Loan Portfolio Composition

	December 31				
(In thousands)	2009	2008	2007	2006	2005
Commercial, financial and agricultural	$ 53,884	53,883	50,797	45,702	44,103
Construction & land development	56,820	67,420	45,724	24,683	26,347
Real estate - mortgage:					
Commercial	156,928	132,818	120,789	109,774	113,714
Residential	97,407	102,835	93,888	92,830	87,873
Consumer installment	11,236	12,463	11,525	9,328	10,315
Total loans	376,275	369,419	322,723	282,317	282,352
Less: unearned income	(172)	(257)	(312)	(334)	(293)
Loans, net of unearned income	376,103	369,162	322,411	281,983	282,059
Less: allowance for loan losses	(6,495)	(4,398)	(4,105)	(4,044)	(3,843)
Loans, net	$ 369,608	364,764	318,306	277,939	278,216

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Table 7 - Loan Maturities and Sensitivities to Changes in Interest Rates

	December 31, 2008								
(Dollars in thousands)		1 year or less	1 to 5 years	After 5 years	Total		Adjustable Rate	Fixed Rate	Total
Commercial, financial and agricultural	$	30,577	19,657	3,650	53,884	$	32,946	20,938	53,884
Construction & land development		48,475	5,111	3,234	56,820		39,603	17,217	56,820
Real estate - mortgage:									
Commercial		12,361	139,679	4,888	156,928		35,770	121,158	156,928
Residential		12,851	31,988	52,568	97,407		54,893	42,514	97,407
Consumer installment		4,563	6,000	673	11,236		1,260	9,976	11,236
Total loans	$	108,827	202,435	65,013	376,275	$	164,472	211,803	376,275

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Table 8 - Allowance for Loan Losses and Nonperforming Assets

	Years ended December 31				
(Dollars in thousands)	**2009**	**2008**	**2007**	**2006**	**2005**
Allowance for loan losses:					
Balance at beginning of period	$ 4,398	4,105	4,044	3,843	3,456
Charge-offs:					
Commercial, financial and agricultural	(495)	(454)	(62)	(37)	(38)
Construction and land development	(2,088)				
Commercial real estate - mortgage					(124)
Residential real estate - mortgage	(704)	(153)	(143)	(106)	(1)
Consumer installment	(61)	(98)	(45)	(46)	(193)
Total charge-offs	(3,348)	(705)	(250)	(189)	(356)
Recoveries:					
Commercial, financial and agricultural	47	102	14	13	94
Construction and land development	50				
Commercial real estate - mortgage			69	7	92
Residential real estate - mortgage	92	6	199	4	3
Consumer installment	6	20	6	36	69
Total recoveries	195	128	288	60	258
Net (charge-offs) recoveries	(3,153)	(577)	38	(129)	(98)
Provision for loan losses	5,250	870	23	330	485
Ending balance	$ 6,495	4,398	4,105	4,044	3,843
as a % of loans	1.73%	1.19	1.27	1.43	1.36
as a % of nonperforming loans	69%	99	918	5,617	3,558
Net charge-offs as a % of average loans	0.84%	0.17	(0.01)	0.05	0.13
Nonperforming assets:					
Nonaccrual/nonperforming loans	$ 9,352	4,431	447	72	108
Other nonperforming assets (primarily other real estate owned)	7,292	324	98		
Total nonperforming assets	$ 16,644	4,755	545	72	108
as a % of loans and foreclosed properties	4.34%	1.29	0.17	0.03	0.04
as a % total assets	2.15%	0.64	0.08	0.01	0.02
Nonperforming loans as a % of total loans	2.49%	1.20	0.14	0.03	0.04
Accruing loans 90 days or more past due	$ 5	104	4		

Table 9 - Allocation of Allowance for Loan Losses

	Years ended December 31									
	2009		2008		2007		2006		2005	
(Dollars in thousands)	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial, financial and agricultural	$ 784	14.3	$ 417	14.6	$ 620	15.7	$ 555	16.2	$ 596	15.6
Construction and land development	2,063	15.1	873	18.3	613	14.2	360	8.7	196	9.3
Real estate - mortgage:										
Commercial	1,264	41.7	1,175	36.0	1,237	37.4	1,367	38.9	1,519	40.3
Residential	1,706	25.9	1,430	27.8	1,214	29.1	1,241	32.9	1,086	31.1
Consumer installment	227	3.0	166	3.4	118	3.6	91	3.3	115	3.7
Unallocated	451		337		303		430		331	
Total allowance for loan losses	$ 6,495	100.0	$ 4,398	100.0	$ 4,105	100.0	$ 4,044	100.0	$ 3,843	100.0

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

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Table 10 - CDs and Other Time Deposits of $100,000 or More

(Dollars in thousands)	**December 31, 2009**
Maturity of:	
3 months or less	$ 38,146
Over 3 months through 6 months	14,115
Over 6 months through 12 months	68,523
Over 12 months	79,697
Total CDs and other time deposits of $100,000 or more	$ 200,481

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Table 11 - Sensitivities to Changes in Interest Rates

						December 31, 2009
(Dollars in thousands)	**Immediate**	**1 to 3 months**	**4 to 12 months**	**1 to 5 years**	**(1) Thereafter**	**Total**
Interest-earning assets:						
Loans, net of unearned income (2)	$	149,844	62,579	157,796	10,765	380,984
Securities - taxable		20,360	64,504	124,480	44,603	253,947
Securities - tax-exempt				749	80,066	80,815
Federal funds sold						
Interest bearing bank deposits	828					828
Total earning assets	828	170,204	127,083	283,025	135,434	716,574
Interest-bearing liabilities:						
Deposits:						
NOW	37,162	47,135				84,297
Savings and money market	83,935	19,800				103,735
Certificates of deposits less than $100,000	1,394	19,991	50,960	42,054		114,399
Certificates of deposits and other time deposits of $100,000 or more	1,601	38,186	82,113	62,828	15,753	200,481
Total interest-bearing deposits	124,092	125,112	133,073	104,882	15,753	502,912
Short-term borrowings	15,960					15,960
Long-term debt		7,219	15,012	63,071	33,047	118,349
Total interest-bearing liabilities	140,052	132,331	148,085	167,953	48,800	637,221
Interest sensitivity gap	(139,224)	37,873	(21,002)	115,072	86,634	79,353
Cumulative interest sensitivity gap	$ (139,224)	(101,351)	(122,353)	(7,281)	79,353	

(1) includes non-rate sensitive items

(2) includes loans held for sale

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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(T). 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, in all material respects, to provide reasonable assurance 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 Principal Financial and Accounting Officer, management has assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2009 in accordance with the criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that such internal control over financial reporting was effective as of December 31, 2009.

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 temporary rules of the Securities and Exchange Commission that permit the Company to provide only 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

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, 2009 and 2008, and the related consolidated statements of earnings, stockholders equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2009. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009 in conformity with U.S. generally accepted accounting principles.

Birmingham, Alabama

March 30, 2010

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

	December 31	
(Dollars in thousands, except share data)	**2009**	**2008**
Assets:		
Cash and due from banks	$ 11,567	$ 14,832
Federal funds sold		20,755
Interest bearing bank deposits	828	846
Cash and cash equivalents	12,395	36,433
Securities available-for-sale	334,762	302,656
Loans held for sale	4,881	3,819
Loans, net of unearned income	376,103	369,162
Allowance for loan losses	(6,495)	(4,398)
Loans, net	369,608	364,764
Premises and equipment, net	8,282	7,778
Bank-owned life insurance	15,719	15,295
Other real estate owned	7,292	324
Other assets	20,443	14,901
Total assets	$ 773,382	$ 745,970
Liabilities:		
Deposits:		
Noninterest-bearing	$ 76,497	$ 78,013
Interest-bearing	502,912	472,830
Total deposits	579,409	550,843
Federal funds purchased and securities sold under agreements to repurchase	15,960	10,910
Long-term debt	118,349	123,368
Accrued expenses and other liabilities	3,481	3,721
Total liabilities	717,199	688,842
Stockholders equity:		
Preferred stock of $.01 par value; authorized 200,000 shares; issued shares - none		
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39

Additional paid-in capital		3,751		3,749
Retained earnings		58,917		59,283
Accumulated other comprehensive income, net		111		603
Less treasury stock, at cost -314,018 shares and 310,188 shares for December 31, 2009 and 2008, respectively		(6,635)		(6,546)
Total stockholders equity		56,183		57,128
Total liabilities and stockholders equity	$	773,382	$	745,970

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

	Years ended December 31		
(Dollars in thousands, except share and per share data)	**2009**	**2008**	**2007**
Interest income:			
Loans, including fees	$ 21,864	$ 22,447	$ 23,016
Securities	14,946	15,839	14,223
Federal funds sold and interest bearing bank deposits	24	75	308
Total interest income	36,834	38,361	37,547
Interest expense:			
Deposits	13,139	15,075	17,052
Short-term borrowings	55	324	601
Long-term debt	4,825	5,092	4,289
Total interest expense	18,019	20,491	21,942
Net interest income	18,815	17,870	15,605
Provision for loan losses	5,250	870	23
Net interest income after provision for loan losses	13,565	17,000	15,582
Noninterest income:			
Service charges on deposit accounts	1,243	1,252	1,302
Mortgage lending	4,048	1,694	2,235
Bank-owned life insurance	424	470	547
Other	1,120	1,954	1,599
Securities (losses) gains, net			
Realized gains, net	2,847	357	253
Total other-than-temporary impairments	(6,807)	(1,525)	
Non-credit porition of other-than-temporary impairments recognized in other comprehensive income	257		
Total securities (losses) gains, net	(3,703)	(1,168)	253
Total noninterest income	3,132	4,202	5,936
Noninterest expense:			
Salaries and benefits	7,819	7,278	7,110
Net occupancy and equipment	1,500	1,314	1,267
Professional fees	799	511	621

FDIC and other regulatory assessments		1,322		358		117
Loss on prepayment of FHLB advances						313
Other		3,193		3,081		2,932
Total noninterest expense		14,633		12,542		12,360
Earnings before income taxes		2,064		8,660		9,158
Income tax (benefit) expense		(340)		2,023		2,240
Net earnings	$	2,404	$	6,637	$	6,918
Net earnings per share:						
Basic and diluted	$	0.66	$	1.81	$	1.86
Weighted average shares outstanding:						
Basic and diluted		3,644,691		3,674,384		3,716,427

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity and Comprehensive Income

(Dollars in thousands, except share and per share data)	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
Balance, December 31, 2006	3,957,135	$ 39	$ 3,748	$ 51,087	$ (2,335)	$ (4,121)	$ 48,418
Comprehensive income:							
Net earnings				6,918			6,918
Other comprehensive income due to change in unrealized gain (loss) on securities available for sale and derivative, net					1,938		1,938
Total comprehensive income				6,918	1,938		8,856
Cash dividends paid ($0.70 per share)				(2,643)			(2,643)
Stock repurchases (61,978 shares)						(1,613)	(1,613)
Balance, December 31, 2007	3,957,135	39	3,748	55,362	(397)	(5,734)	53,018
Comprehensive income:							
Net earnings				6,637			6,637
Other comprehensive income due to change in unrealized gain (loss) on securities available for sale, net					1,000		1,000
Total comprehensive income				6,637	1,000		7,637
Cash dividends paid ($0.74 per share)				(2,716)			(2,716)
Stock repurchases (34,932 shares)						(813)	(813)
Sale of treasury stock (70 shares)			1			1	2
Balance, December 31, 2008	3,957,135	39	3,749	59,283	603	(6,546)	57,128
Comprehensive income:							
Net earnings				2,404			2,404
Other comprehensive loss due to change in other-than-temporary impairment losses related to factors other than credit on available-for-sale, net					(162)		(162)
Other comprehensive loss due to change in unrealized gain (loss) on securities available for sale, net					(330)		(330)

Total comprehensive income				2,404	(492)		1,912
Cash dividends paid ($0.76 per share)				(2,770)			(2,770)
Stock repurchases (3,955 shares)						(90)	(90)
Sale of treasury stock (125 shares)			2			1	3
Balance, December 31, 2009	3,957,135	$ 39	$ 3,751	$ 58,917	$ 111	$ (6,635)	$ 56,183

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

	Years ended December 31		
(In thousands)	**2009**	**2008**	**2007**
Cash flows from operating activities:			
Net earnings	$ 2,404	$ 6,637	$ 6,918
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	5,250	870	23
Depreciation and amortization	705	1,052	423
Premium amortization and discount accretion, net	1,562	5	52
Deferred tax (benefit) expense	(2,190)	(668)	65
Net loss on securities available for sale	1,723	1,168	360
Net gain on sale of loans held for sale	(3,701)	(606)	(626)
Net loss (gain) on nonmarketable equity investments	1,980		(613)
Net (gain) loss on sale of other real estate owned	(64)	8	
Loans originated for sale	(157,041)	(79,947)	(97,477)
Proceeds from sale of loans	158,766	79,712	98,234
Gain on sale of premises and equipment		(1,064)	
Increase in cash surrender value of bank owned life insurance	(424)	(470)	(547)
Loss on prepayment of FHLB advances			313
Net increase in other assets	(4,409)	(979)	(1,612)
Net (decrease) increase in accrued expenses and other liabilities	(240)	298	1,168
Net cash provided by operating activities	4,321	6,016	6,681
Cash flows from investing activities:			
Proceeds from maturities of securities held-to-maturity			89
Proceeds from sales of securities available-for-sale	146,966	67,431	50,207
Proceeds from maturities and calls of securities available-for-sale	105,497	67,933	41,509
Purchase of securities available-for-sale	(288,633)	(119,202)	(105,423)
Net increase in loans	(17,593)	(47,975)	(40,528)
Net purchases of premises and equipment	(824)	(2,210)	(971)
Proceeds from the sale of premises and equipment		1,606	
Proceeds from sale of other real estate owned	724	412	40
Improvements to other real estate owned	(129)		
Net (increase) decrease in FHLB stock	(107)	(452)	526
Proceeds from sale of nonmarketable equity investment			1,146
Net cash used in investing activities	(54,099)	(32,457)	(53,405)
Cash flows from financing activities:			
Net (decrease) increase in noninterest-bearing deposits	(1,516)	7,772	(8,861)
Net increase in interest-bearing deposits	30,082	50,486	31,798
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	5,050	(13,337)	9,846
Net decrease in other short-term borrowings			(10,000)

Proceeds from issuance of long-term debt		18,000	35,000
Repayments or retirement of long-term debt	(5,019)	(10,018)	(10,331)
Stock repurchases	(90)	(813)	(1,613)
Proceeds from sale of treasury stock	3	2	
Dividends paid	(2,770)	(2,716)	(2,643)
Net cash provided by financing activities	25,740	49,376	43,196
Net change in cash and cash equivalents	(24,038)	22,935	(3,528)
Cash and cash equivalents at beginning of period	36,433	13,498	17,026
Cash and cash equivalents at end of period	$ 12,395	$ 36,433	$ 13,498
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Interest	$ 18,560	$ 20,551	$ 21,570
Income taxes	1,830	3,068	1,937
Supplemental disclosure of non-cash transactions:			
Real estate acquired through foreclosure	7,499	647	138
Transfer of securities from held-to-maturity to available-for-sale			424

See accompanying 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 subsidiary, AuburnBank. Significant intercompany transactions 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 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.

Correction of Accounting Errors

Income tax expense for the year ended December 31, 2009 included a $281 thousand tax benefit related to the correction of an error in prior periods that resulted from the incorrect calculation of tax basis for certain available-for-sale securities, primarily related to periods prior to January 1, 2007. Other noninterest income for the year ended December 31, 2008 included a $452 thousand pre-tax charge ($285 thousand after-tax) related to the correction of an error in prior periods that resulted from the incorrect application of the equity method of accounting for an investment in an affordable housing limited partnership, primarily related to the years ended December 31, 2005, 2006 and 2007. Management believes the impact of these corrections are not material to current or prior period financial statements and the Company s Audit Committee of the Board of Directors, based on information reviewed by management with the Audit Committee, concurs with management s conclusion.

Reclassifications

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

Accounting Standards Adopted in 2009

Effective July 1, 2009, the Financial Accounting Standards Board (FASB) established the Accounting Standards Codification (ASC or the Codification) as the source of authoritative generally accepted accounting principles (GAAP) for companies to use in the preparation of financial statements. SEC rules and interpretive releases are also authoritative GAAP for SEC registrants. The guidance contained in the Codification supersedes all existing non-SEC accounting and reporting standards. The Company adopted the Codification, as required, in the third quarter of 2009. As a result, references to accounting literature contained in our financial statement disclosures have been updated to reflect the new Codification structure.

In the first quarter of 2009, the Company adopted new guidance related to the following Codification topics:

FASB ASC 805-10, *Business Combinations* (Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*);

FASB ASC 810-10, *Consolidation* (SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*);

FASB ASC 815-10, *Derivatives and Hedging* (SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133*);

- FASB ASC 820-10, *Fair Value Measurements and Disclosures* (FASB Staff Position (FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*); and

- FASB ASC 320-10, *Investments Debt and Equity Securities* (FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*).

In the second quarter of 2009, the Company adopted new guidance related to the following Codification topics:

- FASB ASC 825-10, *Financial Instruments* (FSP FAS 107-1 and APB Opinion 28-1, *Interim Disclosures about Fair Value of Financial Instruments)*; and

- FASB ASC 855-10, *Subsequent Events* (SFAS No. 165, *Subsequent Events)*.

In the third quarter of 2009, the Company adopted new guidance related to the following Codification topic:

- FASB ASC 105-10, *Generally Accepted Accounting Principles* (SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162*).

In the fourth quarter of 2009, the Company adopted new guidance related to the following Codification topic:

- Accounting Standards Update (ASU or Update) 2009-5, *Measuring Liabilities at Fair Value*.

Information about these pronouncements is described in more detail below.

FASB ASC 805-10 *Business Combinations,* (SFAS No. 141(R), *Business Combinations*) requires an acquirer in a business combination to recognize the assets acquired (including loan receivables), the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date at their fair values as of that date, with limited exceptions. The acquirer is not permitted to recognize a separate valuation allowance as of the acquisition date for loans and other assets acquired in a business combination. The revised statement requires acquisition-related costs to be expensed separately from the acquisition. It also requires restructuring costs that the acquirer expected but was not obligated to incur to be expensed separately from the business combination. This standard was applicable prospectively to business combinations completed on or after January 1, 2009. Adoption of revised FASB ASC 805-10 in the first quarter of 2009 had no impact on the consolidated financial statements of the Company.

FASB ASC 810-10, *Consolidation* (SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*) requires that noncontrolling interests (previously referred to as minority interests) be reported as a component of equity in the balance sheet. Prior to the Company s adoption of this standard, noncontrolling interests were classified outside of equity. This new guidance also changes the way a noncontrolling interest is presented in the income statement such that a parent s consolidated income statement includes amounts attributable to both the parent s interest and the noncontrolling interest. When a subsidiary is deconsolidated, a parent is required to recognize a gain or loss with any remaining interest initially recorded at fair value. Other changes in ownership interest where the parent continues to have a majority ownership interest in the subsidiary are accounted for as capital transactions. This new guidance was effective on January 1, 2009, with prospective application to all noncontrolling interests including those that arose prior to adoption. Retrospective adoption was required for disclosure of noncontrolling interests held as of the adoption date. Adoption of FASB ASC 810-10 in the first quarter of 2009 had no impact on the consolidated financial statements of the Company.

FASB ASC 815-10, *Derivatives and Hedging* (SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133*) changes the disclosure requirements for derivative instruments and hedging activities. It requires enhanced disclosures about how and why an entity uses derivatives, how derivatives and related hedged items are accounted for, and how derivatives and hedged items affect an entity s financial position, performance and cash flows. The Company adopted this pronouncement during the first quarter of 2009. See Note 13 in this report for complete disclosures on derivatives and hedging activities. Adoption of this standard did not affect the Company s consolidated financial results since it amended only the disclosure requirements for derivative instruments and hedged items.

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FASB ASC 820-10, *Fair Value Measurements and Disclosures* (FSP FAS 157-4, Determining *Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* addresses measuring fair value in situations where markets are inactive and transactions are not orderly. The guidance acknowledges that in these circumstances quoted prices may not be determinative of fair value; however, even if there has been a significant decrease in the volume and level of activity for an asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement has not changed. Under the provisions of this standard, price quotes for assets or liabilities in inactive markets may require adjustment due to uncertainty as to whether the underlying transactions are orderly. For inactive markets, there is little information, if any, to evaluate if individual transactions are orderly. Accordingly, the Company is required to estimate, based upon all available facts and circumstances, the degree to which orderly transactions are occurring. The Fair Value Measurements and Disclosures topic in the Codification does not prescribe a specific method for adjusting transaction or quoted prices; however, it does provide guidance for determining how much weight to give transaction or quoted prices. Price quotes based upon transactions that are not orderly are not considered to be determinative of fair value and should be given little, if any, weight in measuring fair value. Price quotes based upon transactions that are orderly shall be considered in determining fair value, with the weight given based upon the facts and circumstances. If sufficient information is not available to determine if price quotes are based upon orderly transactions, less weight should be given to the price quote relative to other transactions that are known to be orderly. The new measurement provisions of FASB ASC 820-10 were effective for second quarter 2009; however, as permitted under the pronouncement, the Company early adopted in first quarter 2009 and the effects of adoption were not significant.

FASB ASC 320-10, *Investments Debt and Equity Securities* (FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*) states that an other-than-temporary impairment write-down of a debt security, where fair value is below amortized cost, is triggered in circumstances where (1) an entity has the intent to sell a security, (2) it is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more likely than not the entity will be required to sell the security before recovery, an other-than-temporary impairment write-down is recognized in earnings equal to the entire difference between the security s amortized cost basis and its fair value. If an entity does not intend to sell the security or it is more likely than not that it will not be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income. The new accounting requirements for recording other-than-temporary impairment on debt securities were effective for second quarter 2009; however, as permitted under the pronouncement, the Company early adopted on January 1, 2009. No adjustment was made to the beginning balance of retained earnings. See Note 2 in this report for additional disclosures required by FASB ASC 320-10.

FASB ASC 825-10, *Financial Instruments* (FSP FAS 107-1 and APB Opinion 28-1, *Interim Disclosures about Fair Value of Financial Instruments)* states that entities must disclose the fair value of financial instruments in interim reporting periods as well as in annual financial statements. Entities must also disclose the methods and assumptions used to estimate fair value as well as any changes in methods and assumptions that occurred during the reporting period. The Company adopted this pronouncement in the second quarter of 2009. See Note 16 in this report for additional information. Because the new provisions in FASB ASC 825-10 amend only the disclosure requirements related to the fair value of financial instruments, adoption of this pronouncement did not affect the Company s consolidated financial results.

FASB ASC 855-10, *Subsequent Events* (SFAS No. 165, *Subsequent Events)* describes two types of subsequent events that previously were addressed in the auditing literature, one that requires post-period end adjustment to the financial statements being issued, and one that requires footnote disclosure only. Companies are also required to disclose the date through which management has evaluated subsequent events, which for public entities is the date that financial statements are issued. The requirements for disclosing subsequent events were effective in the second quarter of 2009 with prospective application. Adoption of this standard did not have a significant impact on the consolidated financial statements of the Company. See Note 1 (Summary of Significant Accounting Policies) in this report for the Company s discussion of subsequent events.

ASU 2009-5, *Measuring Liabilities at Fair Value,* under ASC 820 provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities or similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles of ASC 820, such as an income approach or market approach. The new authoritative accounting guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. This guidance was effective in the fourth quarter of 2009 with adoption applied prospectively. Adoption of this standard did not have a significant impact on the Company s consolidated financial statements.

Cash Equivalents

Cash on hand, cash items in process of collection, amounts due from banks, and federal funds sold are included in cash and cash equivalents.

Securities

Securities are classified based on management s intention at the date of purchase. At December 31, 2009, 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 loss, net of the deferred income tax effects. Interest and dividends on securities, including the amortization of premiums and accretion of discounts are calculated using a method that approximates the effective interest method over the anticipated life of the security, taking into consideration prepayment assumptions. Realized gains and losses from the sale of securities are determined using the specific identification method.

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

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the entity will be required to sell the debt security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that 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 are carried at the lower of cost or estimated fair value as determined on a loan-by-loan basis. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

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 as an adjustment to the related loan yield using a method that approximates the interest method. Loan commitment fees are generally deferred and amortized on a straight-line basis over the commitment period.

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 are reversed against current income. Interest income is subsequently recognized only to the extent cash payments are received.

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.

Impaired loans also include loans that management may elect to formally restructure due to the weakening credit status of a borrower such that the restructuring may facilitate a repayment plan that minimizes potential losses, if any, that the Company may have to otherwise incur. The primary restructuring methods offered to borrowers are reductions in interest rates and extension in terms. Loans which are determined to be troubled debt restructurings (TDR) are placed in nonaccrual status. 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 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 and amortization 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 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. Additional losses related to OREO for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense. Any gains or losses realized at the time of disposal are also reflected in other noninterest expense.

Nonmarketable equity investments

Nonmarketable equity investments include equity securities that are not publicly traded and securities acquired for various purposes, such as to meet regulatory requirements (for example, Federal Reserve Bank and Federal Home Loan Bank stock). These securities are accounted for under the cost method or are carried at fair value 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 financial assets are accounted for as sales (i.e. loan 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.

Mortgage Servicing Rights

The Company recognizes as assets the rights to service mortgage loans for others, known as MSRs. The Company determines the fair value of MSRs at the date the loan is transferred. To determine the fair value of MSRs, the Company engages an independent third party. The independent third party s valuation model calculates the present value of estimated future net servicing income using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees.

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

Derivative Instruments

In accordance with FASB 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 a hedge, 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

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. 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 on the consolidated balance sheets.

In accordance with ASC 740, 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. The adoption had no material affect on the Company s financial statements. 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 subsidiary file a consolidated income tax return.

Fair Value Measurements

In September 2006, the FASB issued ASC Topic 820, *Fair Value Measurements*. FASB ASC 820, 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. FASB ASC 820 applies only to fair-value measurements that are already required or permitted by other accounting standards and is expected to increase the consistency of those measurements. 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 15.

Subsequent Events

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to period end December 31, 2009. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

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Earnings Per Share

Basic net earnings per share are 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 if the Company s potential common stock was issued. As of December 31, 2009, 2008 and 2007, the Company had no options issued or outstanding.

A reconciliation of the numerator and denominator of the basic earnings per share computation to the diluted earnings per share computation for the years ended December 31, 2009, 2008 and 2007, respectively, is presented below.

	Years ended December 31		
(Dollars in thousands, except share and per share data)	**2009**	**2008**	**2007**
Basic:			
Net earnings	$ 2,404	$ 6,637	$ 6,918
Average common shares outstanding	3,644,691	3,674,384	3,716,427
Earnings per share	$ 0.66	$ 1.81	$ 1.86
Diluted:			
Net earnings	$ 2,404	$ 6,637	$ 6,918
Average common shares outstanding	3,644,691	3,674,384	3,716,427
Dilutive effect of options issued			
Average diluted shares outstanding	3,644,691	3,674,384	3,716,427
Earnings per share	$ 0.66	$ 1.81	$ 1.86

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NOTE 2: SECURITIES

At December 31, 2009 and 2008, respectively, all securities within the scope of FASB ASC 320, *Investments Debt and Equity Securities* (SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*) were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at December 31, 2009 and 2008, respectively, are presented below.

	December 31, 2009							
	1 year	**1 to 5**	**5 to 10**	**After 10**	**Fair**	**Gross Unrealized**		**Amortized**
(Dollars in thousands)	**or less**	**years**	**years**	**years**	**Value**	**Gains**	**Losses**	**cost**
Available-for-sale:								
Agency obligations (a)	$		42,626	47,594	90,220	363	630	90,487
Agency RMBS (a)			5,261	153,381	158,642	3,264	380	155,758
State and political subdivisions		382	16,073	65,107	81,562	1,031	578	81,109
Trust preferred securities:								
Pooled				23	23		257	280
Individual issuer				1,440	1,440		2,010	3,450
Corporate debt		2,142	733		2,875		626	3,501
Total available-for-sale	$	2,524	64,693	267,545	334,762	4,658	4,481	334,585

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

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

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

Securities with aggregate fair values of $203.4 million and $204.1 million at December 31, 2009 and 2008, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

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

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Gross Unrealized Losses and Fair Value

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

(Dollars in thousands)	Less than 12 months			12 months or longer		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2009:							
Agency obligations	$	46,219	630			46,219	630
Agency RMBS		48,343	380			48,343	380
State and political subdivisions		18,868	351	2,837	227	21,705	578
Trust preferred securities:							
Pooled		13	37	10	220	23	257
Individual issuer				1,440	2,010	1,440	2,010
Corporate debt				2,876	626	2,876	626
Total	$	113,443	1,398	7,163	3,083	120,606	4,481
December 31, 2008:							
Agency obligations	$						
Agency RMBS		6,367	40	4,162	40	10,529	80
Private label RMBS		5,579	152			5,579	152
State and political subdivisions		30,254	1,626	1,178	140	31,432	1,766
Trust preferred securities:							
Pooled		740	1,260			740	1,260
Individual issuer		2,524	1,351	1,035	415	3,559	1,766
Corporate debt		3,431	72			3,431	72
Total	$	48,895	4,501	6,375	595	55,270	5,096

The applicable date for determining when securities are in an unrealized loss position is December 31, 2009. As such, it is possible that a security had a market value that exceeded its amortized cost on other days during the past twelve-month period.

For the securities in the above table, the Company does not have the intent to sell and 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 has assessed each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

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

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

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

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

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

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

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

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

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

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

Agency obligations

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

Agency residential mortgage-backed securities (RMBS)

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

Securities of U.S. states and political subdivisions

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

Pooled trust preferred securities

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

Individual issuer trust preferred securities

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

Corporate debt securities

The unrealized losses associated with corporate debt securities are primarily related to securities backed by an individual issuer community bank. The Company evaluates the financial performance of the issuer on a quarterly basis to determine if it is probable that the issuer can make all contractual principal and interest payments. Based upon its evaluation, the Company expects to recover the entire amortized cost basis of these securities.

Cost-method investments

At December 31, 2009, cost-method investments with an aggregate cost of $6.0 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

The carrying values of the Company s investment securities could decline in the future if the underlying performance of the collateral for pooled trust preferred securities, the financial condition of individual issuers of trust preferred securities, or the credit quality of other securities deteriorate and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that significant other-than-temporary impairment charges may occur in the future given the current economic environment.

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

Trust Preferred Securities as of December 31, 2009

	Credit Rating			Unrealized losses			Life-to-date Impairment
(Dollars in thousands)	Moody s	Fitch	Fair value	Less than 12 months	12 months or longer	Total	Charges
Pooled:							
ALESCO Preferred Funding XVII, Ltd. (a)	Ca	B	$ 10	$	220	220	$ 1,770
U.S. Capital Funding IV, Ltd. (b)	Ca	CC	13	37		37	2,450
Total pooled			23	37	220	257	4,220
Individual issuer (c):							
Carolina Financial Capital Trust I	n/a	n/a	90		360	360	
Main Street Bank Statutory Trust I (d)	n/a	n/a	275		225	225	
MNB Capital Trust I	n/a	n/a	125		375	375	
PrimeSouth Capital Trust I	n/a	n/a	125		375	375	
TCB Trust	n/a	n/a	325		175	175	
United Community Capital Trust	n/a	n/a	500		500	500	
Total individual issuer			1,440		2,010	2,010	
Total trust preferred securities			$ 1,463	$ 37	2,230	2,267	$ 4,220

n/a - not applicable, securities not rated.

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

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

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

(d) Issuer acquired by BB&T Corporation.

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Trust Preferred Securities as of December 31, 2008

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

n/a - not applicable, securities not rated.

(a) Class B Deferrable Third Priority Secured Floating Rate Notes. The underlying collateral is primarily composed of community banks and thrifts.
(b) Class B-2 Fixed/Floating Rate Senior Surbordinate Notes. The underlying collateral is primarily composed of community banks and thrifts.
(c) 144A Floating Rate Capital Securities. Underlying issuer is a community bank holding company. Securities have no excess subordination or overcollateralization.
(d) Community Financial Services now known as Silverton.
(e) Issuer acquired by BB&T Corporation.

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

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

At December 31, 2009, there was no excess subordination for the Class B notes of ALESCO Preferred Funding XVII, Ltd., compared to approximately $115.9 million in excess subordination or approximately 31.6% of performing collateral at December 31, 2008. At December 31, 2009 and 2008, respectively, there was no excess subordination for the B-2 notes of U.S. Capital Funding IV, Ltd.

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Other-Than-Temporarily Impaired Securities

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

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

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and the credit component of the loss is recognized in earnings (referred to as credit-impaired debt securities). Other-than-temporary impairments recognized in earnings for the year ended December 31, 2009 for credit-impaired debt securities are presented as additions in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). The credit loss component is reduced if the Company sells, intends to sell or believes it will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if the Company receives cash flows in excess of what it expected to receive over the remaining life of the credit-impaired debt security or the security matures. Changes in the credit loss component of credit-impaired debt securities were:

(Dollars in thousands)	**Year ended December 31, 2009**
Balance, beginning of period	$
Additions:	
Initial credit impairments	2,663
Subsequent credit impairments	1,907
Reductions:	
Securities sold	
Due to change in intent to sell or requirement to sell	
Increases in expected cash flows	
Balance, end of period	$ 4,570

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Other-Than-Temporary Impairment

The following table presents details of total other-than-temporary impairment related to debt securities available-for-sale, and cost-method investments, for the year ended December 31, 2009. Other-than-temporary impairment charges included in earnings for the year ended December 31, 2008 related to pooled trust preferred securities and were approximately $1.5 million.

(Dollars in thousands)	Year ended December 31, 2009
Other-than-temporary impairment charges (included in earnings):	
Debt securities:	
Pooled trust preferred securities	$ 2,695
Individual issuer trust preferred securities	1,875
Total debt securities	4,570
Cost-method investments	1,980
Total other-than-temporary impairment charges	$ 6,550
Other-than-temporary impairment on debt securities:	
Recorded as part of gross realized losses:	
Credit-related	$ 4,570
Securities with intent to sell	
Recorded directly to other comprehensive income for non-credit related impairment	257
Total other-than-temporary impairment on debt securities	$ 4,827

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

Realized Gains and Losses

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

	Years ended December 31		
(Dollars in thousands)	2009	2008	2007
Gross realized gains	$ 2,881	$ 406	$ 860
Gross realized losses	(6,584)	(1,574)	(607)
Net realized gains (losses)	$ (3,703)	$ (1,168)	$ 253

NOTE 3: LOANS, NET OF UNEARNED INCOME

	December 31	
(In thousands)	2009	2008
Commercial, financial and agricultural	$ 53,884	$ 53,883
Construction and land development	56,820	67,420
Real estate - mortgage:		

Commercial	156,928	132,818
Residential	97,407	102,835
Consumer installment	11,236	12,463
Total loans	376,275	369,419
Less: unearned income	(172)	(257)
Loans, net of unearned income	$ 376,103	$ 369,162

Loans secured by real estate were approximately 82.7% of the total loan portfolio at December 31, 2009. Due to declines in economic indicators and real estate values, loans secured by real estate may have a greater risk of non-collection than other loans. At December 31, 2009, the Company s geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

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At December 31, 2009 and 2008, nonaccrual loans amounted to $9.4 million and $4.4 million, respectively. The gross interest income which would have been recorded under the original terms of those loans amount to approximately $161 thousand, $199 thousand, and $15 thousand for the years ended December 31, 2009, 2008, and 2007, respectively. At December 31, 2009 and 2008, loans 90 days past due and still accruing interest amounted to $5 thousand and $104 thousand, respectively.

The following table sets forth certain information regarding the Company s impaired loans that were evaluated for specific reserves at December 31, 2009 and 2008, respectively.

	December 31	
(In thousands)	2009	2008
Total recorded investment with no related valuation allowance	$ 4,360	$ 4,329
Total recorded investment with related valuation allowance	5,380	
Total recorded investment - impaired loans	9,740	4,329
Less: allowance for loan losses assigned to impaired loans	(1,310)	
Impaired loans, net	$ 8,430	$ 4,329

No valuation allowance was established for impaired loans at December 31, 2008 because the fair value of the collateral less estimated selling costs was greater than the Company s recorded investment in the impaired loan. For the years ended December 31, 2009 and 2008, the average recorded investments in impaired loans were $4.0 million and $2.6 million, respectively. For the year ended December 31, 2007, the Company had no average recorded investment in impaired loans. Total interest income recognized on impaired loans for the years ended December 31, 2009, 2008, and 2007 was not significant.

NOTE 4: ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses for the years ended December 31, 2009, 2008 and 2007, is presented below.

	Years ended December 31		
(Dollars in thousands)	2009	2008	2007
Balance at beginning of period	$ 4,398	$ 4,105	$ 4,044
Charge-offs	(3,348)	(705)	(250)
Recoveries	195	128	288
Net (charge-offs) recoveries	(3,153)	(577)	38
Provision for loan losses	5,250	870	23
Ending balance	$ 6,495	$ 4,398	$ 4,105

NOTE 5: PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2009 and 2008 is presented below.

	December 31	
(Dollars in thousands)	**2009**	**2008**
Land	$ 4,678	$ 4,672
Buildings and improvements	6,610	5,467
Furniture, fixtures, and equipment	3,565	3,535
Construction in progress	63	551
Total premises and equipment	14,916	14,225
Less: Accumulated depreciation	(6,634)	(6,447)
Premises and equipment, net	$ 8,282	$ 7,778

Depreciation expense was approximately $320 thousand, $312 thousand, and $344 thousand for each of the years in the three-year period ended December 31, 2009.

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NOTE 6: MORTGAGE SERVICING RIGHTS, NET

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

The Company has recorded MSRs related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. Prior to January 1, 2009, the volume of loans sold servicing retained was not significant; therefore no servicing rights were capitalized.

The change in amortized MSRs and the related valuation allowance for the year ended December 31, 2009 is presented below.

(Dollars in thousands)		**Year ended December 31, 2009**
Beginning Balance	$	
Additions		914
Amortization expense		(80)
Change in valuation allowance		
Ending Balance	$	834
Fair value of amortized MSRs:		
Beginning of year		
End of year	$	978

At December 31, 2009, there was no valuation allowance for amortized MSRs. The Company periodically evaluates mortgage servicing rights for impairment. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation reserve is established. The valuation reserve is adjusted as the fair value changes.

Data and assumptions used in the fair value calculation related to MSRs at December 31, 2009 are presented below.

(Dollars in thousands)		**December 31, 2009**	
Unpaid principal balance	$	106,313	
Weighted average prepayment speed (CPR)		10.0	%
Discount rate (annual percentage)		11.0	%
Weighted average coupon interest rate		4.8	%
Weighted average remaining maturity (months)		311	
Weighted average servicing fee (basis points)		25.0	

At December 31, 2009, the weighted average amortization period for amortized MSRs is 7.2 years. Estimated amortization expense for each of the next five years is presented below.

(Dollars in thousands)		**December 31, 2009**
2010	$	116
2011		102

2012	90
2013	79
2014	70

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NOTE 7: DEPOSITS

At December 31, 2009, the scheduled maturities of certificates of deposit and other time deposits are presented below.

(Dollars in thousands)	**December 31, 2009**
2010	$ 192,806
2011	39,910
2012	24,036
2013	20,080
2014	22,295
Thereafter	15,753
Total certificates of deposit and other time deposits	$ 314,880

Additionally, at December 31, 2009 and 2008, approximately $200.5 million, respectively, of certificates of deposit and other time deposits were issued in denominations of $100,000 or greater.

At December 31, 2009 and 2008, the amount of deposit accounts in overdraft status that were reclassified to loans on the accompanying consolidated balance sheets was not material.

NOTE 8: SHORT-TERM BORROWINGS

	2009		**2008**		**2007**	
(Dollars in thousands)	**Amount**	**Weighted Avg. Rate**	**Amount**	**Weighted Avg. Rate**	**Amount**	**Weighted Avg. Rate**
Federal funds purchased and securities sold under agreements to repurchase:						
As of December 31	$ 15,960	0.83 %	$ 10,910	0.04 %	$ 24,247	3.76 %
Average during the year	10,790	0.51	16,604	1.95	11,536	4.73
Maximum outstanding at any month-end	15,960		27,315		24,247	
Other short-term borrowings:						
As of December 31	$	%	$	%	$	%
Average during the year					1,096	5.44
Maximum outstanding at any month-end					10,000	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling $34.0 million with $12.5 million outstanding at December 31, 2009.

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 $9.7 million and $11.0 million at December 31, 2009 and 2008, respectively, were pledged to secure securities sold under agreements to repurchase.

Other short-term borrowings include FHLB advances with an original maturity of one year or less. FHLB advances are collateralized by securities from the Company s securities portfolio and a blanket lien on certain qualifying single-family loans held in the Company s loan portfolio. At December 31, 2009 and 2008, respectively, there were no other short-term borrowings outstanding.

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NOTE 9: LONG-TERM DEBT

At December 31, 2009 and 2008, the composition of long-term debt is presented below.

	2009		2008	
(Dollars in thousands)	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
FHLB advances, due 2010 to 2018	$ 86,132	4.01 %	$ 91,151	3.94 %
Securities sold under agreements to repurchase (original maturity greater than one year), due 2011 to 2017	25,000	4.08	25,000	4.08
Subordinated debentures, due 2033	7,217	3.38	7,217	5.13
Total long-term debt	$ 118,349	3.99 %	$ 123,368	4.34 %

The Bank had $86.1 million and $91.2 million of FHLB advances with original maturities greater than one year at December 31, 2009 and 2008, respectively. Securities with an aggregate carrying value of $62.6 million and $64.2 million and certain qualifying residential mortgage loans with an aggregate carrying value of $49.3 million and $57.6 million at December 31, 2009 and 2008, respectively, were pledged to secure long-term FHLB advances.

The Bank had $25.0 million in securities sold under agreements to repurchase with an original maturity greater than one year at both December 31, 2009 and 2008. Securities with an aggregate carrying value of $28.5 million and $30.7 million at December 31, 2009 and 2008, respectively, were pledged to secure long-term securities sold under agreements to repurchase.

The Company formed Auburn National Bancorporation Capital Trust I (Trust), 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 may be redeemed on or after December 31, 2008.

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

(Dollars in thousands)	2010	2011	2012	2013	2014	Thereafter	Total
FHLB advances	$ 15,018	8,018	15,018	15,018	10,018	23,042	86,132
Securities sold under agreements to repurchase (with an original maturity greater than one year)		5,000	5,000			15,000	25,000
Subordinated debentures						7,217	7,217
Total long-term debt	$ 15,018	13,018	20,018	15,018	10,018	45,259	118,349

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NOTE 10: OTHER COMPREHENSIVE INCOME (LOSS)

Comprehensive income is defined as the change in equity from all transactions other than those with shareholders, and it includes net earnings and other comprehensive income (loss). Other comprehensive income (loss) for the years ended December 31, 2009, 2008, and 2007, is presented below.

(In thousands)	Pre-tax amount	Tax benefit (expense)	Net of tax amount
2009:			
Unrealized net holding loss on other-than-temporarily impaired securities due to factors other than credit	$ (257)	95	(162)
Unrealized net holding loss on all other securities	(4,226)	1,559	(2,667)
Reclassification adjustment for losses on securities recognized in net earnings	3,703	(1,366)	2,337
Other comprehensive loss	$ (780)	288	(492)
2008:			
Unrealized net holding gain on securities	$ 450	(187)	263
Reclassification adjustment for losses on securities recognized in net earnings	1,168	(431)	737
Other comprehensive income	$ 1,618	(618)	1,000
2007:			
Unrealized net holding gain on securities	$ 3,483	(1,393)	2,090
Reclassification adjustment for gains on securities recognized in net earnings	(253)	101	(152)
Other comprehensive income	$ 3,230	(1,292)	1,938

NOTE 11: INCOME TAXES

For the years ended December 31, 2009, 2008, and 2007 the components of income tax (benefit) expense from continuing operations are presented below.

	Years ended December 31		
(Dollars in thousands)	2009	2008	2007
Current income taxes:			
Federal	$ 1,563	2,321	2,078
State	287	370	97
Total current income taxes	1,850	2,691	2,175

Deferred income taxes:				
Federal		(1,930)	(589)	(82)
State		(260)	(79)	147
Total deferred income taxes		(2,190)	(668)	65
Total income tax (benefit) expense	$	(340)	2,023	2,240

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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, 2009, 2008 and 2007, is presented below. As discussed in Footnote 1, income tax expense for the year ended December 31, 2009 included a $281 thousand tax benefit related to the correction of an error in prior periods. The error resulted from the incorrect calculation of tax basis for certain available-for-sale securities, primarily related to periods prior to January 1, 2007.

	2009		2008		2007	
(Dollars in thousands)	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings
Earnings before income taxes	$ 2,064		$ 8,660		$ 9,158	
Income taxes at statutory rate	702	34.0 %	2,944	34.0 %	3,114	34.0 %
Tax-exempt interest	(939)	(45.5)	(779)	(9.0)	(625)	(6.8)
State income taxes, net of federal tax effect	44	2.1	192	2.2	161	1.8
Low-income housing credit	(228)	(11.0)	(228)	(2.6)	(228)	(2.5)
Bank owned life insurance	(144)	(7.0)	(160)	(1.8)	(186)	(2.0)
Change in valuation allowance	505	24.5				
Correction of prior period error	(281)	(13.6)				
Other	1	0.0	54	0.6	4	0.0
Total income tax (benefit) expense	$ (340)	(16.5) %	2,023	23.4 %	2,240	24.5 %

The Company recorded an income tax benefit for the year-ended December 31, 2009 primarily due to a decrease in pre-tax income relative to tax-exempt sources of income.

The Company had net deferred tax assets of $3.7 million and $1.2 million at December 31, 2009 and 2008, respectively. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2009 and 2008 are presented below:

	December 31	
(Dollars in thousands)	2009	2008
Deferred tax assets:		
Allowance for loan losses	$ 2,397	1,647
Securities	2,454	581
Other assets	186	137
Other	38	30

Total deferred tax assets		5,075	2,395
Less: valuation allowance for nondeductible capital losses		(505)	
Total deferred tax assets less valuation allowance		4,570	2,395
Deferred tax liabilities:			
Depreciation		189	194
Discount accretion		165	499
Unrealized gain on securities		65	353
FHLB stock dividends		24	19
Prepaid expenses		79	81
Deferred loan fees		57	44
Originated mortgage servicing rights		308	
Total deferred tax liabilities		887	1,190
Net deferred tax asset	$	3,683	1,205

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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.

Management determined that a valuation allowance was required for the year ended December 31, 2009 in the amount of $505 thousand primarily attributable to a deferred tax asset created by a capital loss for income tax purposes on an investment in the common stock of Silverton Financial Services, Inc, the holding company of Silverton Bank, which failed on May 1, 2009. The valuation allowance reduced the deferred tax asset created by the worthless securities to an amount that management believes will more-likely-than-not be realized. 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 the remaining deferred tax assets at December 31, 2009. 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, 2009, 2008 and 2007, is presented below.

	Years ended December 31			
(Dollars in thousands)		**2009**	**2008**	**2007**
Net deferred tax asset:				
Balance, beginning of year	$	1,205	1,155	2,512
Deferred tax (expense) benefit related to continuing operations		2,190	668	(65)
Stockholders equity, for accumulated other comprehensive loss (income)		288	(618)	(1,292)
Balance, end of year	$	3,683	1,205	1,155

ASC 740 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 derecognition, measurement and classification of income tax uncertainties in interim periods. As of December 31, 2009, 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 2010 relative to any tax positions taken prior to December 31, 2009. As of December 31, 2009, 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 for the years ended December 31, 2006 through 2009. The Company is currently open to audit by the State of Alabama for the years ended December 31, 2006, through 2009, although certain matters have been closed.

NOTE 12: 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 $120 thousand, $119 thousand, and $109 thousand for the years ended December 31, 2009, 2008, and 2007, respectively, and are included in salaries and benefits expense.

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NOTE 13: DERIVATIVE INSTRUMENTS

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current earnings. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these instruments to meet customer needs, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2009 the Company had no derivative contracts to assist in managing interest rate sensitivity.

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

A summary of the Company s interest rate swaps as of and for the year ended December 31, 2009 is presented below.

(Dollars in thousands)	Notional	Other Assets Estimated Fair Value	Other Liabilities Estimated Fair Value	Other noninterest income Gains (Losses)
Interest rate swap agreements:				
Pay fixed / receive variable	$ 6,417	$	$ 931	$ 649
Pay variable / receive fixed	6,417	931		(649)
Total interest rate swap agreements	$ 12,834	$ 931	$ 931	$

NOTE 14: 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, 2009 and 2008, the following financial instruments were outstanding whose contract amount represents credit risk:

	December 31	
	2009	2008
(Dollars in thousands)		

Commitments to extend credit	$ 46,505	$ 39,582
Standby letters of credit	8,116	9,265

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. 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. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. 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 supporting 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 $90 thousand and $89 thousand at December 31, 2009 and 2008, respectively.

Other Commitments

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2009, are as follows: 2010, $179 thousand; 2011, $120 thousand; 2012, $78 thousand; 2013, $27 thousand; 2014, none.

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 affect upon the consolidated financial condition or results of operations of the Company and the Bank.

NOTE 15: FAIR VALUE DISCLOSURES

Fair value is defined by FASB ASC 820, *Fair Value Measurements and Disclosures*, (SFAS No. 157, *Fair Value Measurements*) as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FASB ASC 820 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company s assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

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

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

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

The Company s assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy in accordance with FASB ASC 820.

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

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

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

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

Loans, net Loans considered impaired under FASB ASC 310-10-35, *Receivables* (SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by SFAS No. 118, *Accounting by Creditors for Impairment of a Loan Income Recognition and Disclosure*) are loans for which, based on current information and events, it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are subject to nonrecurring fair value adjustments to reflect (1) partial write-downs that are based on the observable market price or current appraised value of the collateral, or (2) the full charge-off of the loan carrying value. All of the Company s impaired loans are classified within Level 3 of the valuation hierarchy.

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

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

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 and are subjected to nonrecurring fair value adjustments. MSRs do not trade in an active market with readily observable prices. To determine the fair value of MSRs, the Company engages an independent third party. The independent third party s valuation model calculates the present value of estimated future net servicing income using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Because the valuation of MSRs requires the use of significant unobservable inputs, all of the Company s MSRs are classified within Level 3 of the valuation hierarchy.

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

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Assets and liabilities measured at fair value on a recurring basis

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of December 31, 2009 and December 31, 2008, respectively, by caption, on the consolidated balance sheets by FASB ASC 820 valuation hierarchy (as described above):

(Dollars in thousands)	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2009:				
Securities available-for-sale:				
Agency obligations	$ 90,220		90,220	
Agency RMBS	158,642		158,642	
States and political subdivisions	81,562		81,562	
Trust preferred securities:				
Pooled	23			23
Individual issuer	1,440			1,440
Corporate debt	2,875		2,875	
Total securities available-for-sale	334,762		333,299	1,463
Other assets	931		931	
Total assets at fair value	$ 335,693		334,230	1,463
Other liabilities	$ 931		931	
Total liabilities at fair value	$ 931		931	
December 31, 2008:				
Securities available-for-sale:				
Agency obligations	$ 68,001		68,001	
Agency RMBS	155,079		155,079	
Private label RMBS	5,579		5,579	
States and political subdivisions	65,292		65,292	
Trust preferred securities:				
Pooled	1,715			1,715
Individual issuer	3,559			3,559
Corporate debt	3,431			3,431
Total securities available-for-sale	$ 302,656		293,951	8,705
Other assets	1,580		1,580	
Total assets at fair value	$ 304,236		295,531	8,705

Other liabilities	$	1,580	1,580
Total liabilities at fair value	$	1,580	1,580

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

(Dollars in thousands)		**Year ended December 31, 2009**
Beginning balance	$	8,705
Total realized and unrealized gains and (losses):		
Included in net earnings		(5,234)
Included in other comprehensive income		605
Purchases, issuances and settlements		
Transfers in and/or (out) of Level 3		(2,613)
Ending balance	$	1,463

Assets and liabilities measured at fair value on a nonrecurring basis

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2009 and December 31, 2008, respectively, by caption, on the consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above):

(Dollars in thousands)		**Amount**	**Active Markets for Identical Assets (Level 1)**	**Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
December 31, 2009:					
Loans held for sale	$	4,881		4,881	
Loans, net [(1)]		8,430			8,430
Other real estate		7,292			7,292
Other assets [(2)]		834			834
Total assets at fair value	$	21,437		4,881	16,556
December 31, 2008:					
Loans held for sale	$	3,819		3,819	
Loans, net [(1)]		4,329			4,329
Other real estate		324			324
Total assets at fair value	$	8,472		3,819	4,653

(1) Loans considered impaired under FASB ASC 310-10-35, *Receivables*.
(2) Mortgage servicing rights, net included in this category.

NOTE 16: FAIR VALUE OF FINANCIAL INSTRUMENTS

FASB ASC 825, *Financial Instruments*, (SFAS No. 107, *Disclosures about Fair Value of Financial Instruments)* requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company s financial instruments are explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow and other valuation techniques. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent markets and should not be considered representative of the liquidation value of the Company s financial instruments, but rather a good faith estimate of the fair value of financial instruments held by the Company. FASB ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

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

Cash and cash equivalents

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

Securities

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

Loans held for sale

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

Loans, net

The fair value of loans is calculated using discounted cash flows. The discount rates used to determine the present value of the loan portfolio are estimated market discount rates that reflect the credit and interest rate risk inherent in the loan portfolio. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by FASB ASC 820 and generally produces a higher value than an exit-price approach. The estimated maturities are based on the Company s historical experience with repayments adjusted to estimate the effect of current market conditions. The carrying amount of accrued interest approximates its fair value.

Deposits

Under FASB ASC 825, the fair value of deposits with no stated maturity, such as noninterest bearing demand deposits, interest bearing demand deposits and savings and certain types of money market accounts, is equal to the amount payable on demand at the reporting date (i.e., their carrying amount). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using discounted cash flows. The discount rates used are based on estimated market rates for deposits of similar remaining maturities.

Short-term borrowings

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

Long term debt

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

Derivative Instruments

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

Off-balance sheet Instruments

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

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

	December 31, 2009		December 31, 2008	
(Dollars in thousands)	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial Assets:				
Cash and cash equivalents	$ 12,395	$ 12,395	$ 36,433	$ 36,433
Securities	334,762	334,762	302,656	302,656
Loans held for sale	4,881	4,881	3,819	3,819
Loans, net	369,608	373,940	364,764	366,994
Derivative Assets	931	931	1,580	1,580
Financial Liabilities:				
Deposits	$ 579,409	$ 585,597	$ 550,843	$ 557,452
Short-term borrowings	15,960	15,960	10,910	10,910
Long-term debt	118,349	124,004	123,368	134,110
Derivative Liabilities	931	931	1,580	1,580

NOTE 17: RELATED PARTY TRANSACTIONS

A director of the Company is an officer in a construction company that the Company contracted with during the years ended December 31, 2009 and 2008 for the construction of a new branch facility. Total payments made to the construction company under the terms of the construction contract were $587 thousand and $308 thousand for the years ended December 31, 2009 and 2008, 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.

(Dollars in thousands)	Amount
Loans outstanding at December 31, 2008	$ 3,629
New loans/advances	2,715
Repayments	(4,253)
Changes in directors and executive officers	1,166
Loans outstanding at December 31, 2009	$ 3,257

During 2009 and 2008, 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, 2009 and 2008 amounted to $17.8 million and $19.0 million, respectively.

NOTE 18: REGULATORY RESTRICTIONS AND CAPITAL RATIOS

The Company and the Bank are subject to various regulatory capital requirements administered by federal banking agencies. 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, and the Federal Reserve is encouraging the maintenance of higher levels of capital well above the minimum ratios. 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) Tier 1 leverage capital ratio, Tier 1 risk-based ratio and total risk-based ratio (defined in regulations, see Supervision and Regulation). Management

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believes, as of December 31, 2009, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2009, the Bank is well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk based, Tier I risk based, and Tier I leverage ratios as set forth in the table. Management is not aware of any conditions or events since that notification that management believes have changed the Bank s capital category.

The actual capital amounts and ratios and the aforementioned minimums as of December 31, 2009 and 2008 are presented below.

	Actual		**Minimum for capital adequacy purposes**		**Minimum to be well capitalized**	
(Dollars in thousands)	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
At December 31, 2009:						
Tier 1 Leverage Capital						
Auburn National Bancorporation	$ 63,176	8.13 %	$ 31,095	4.00 %	N/A	N/A
AuburnBank	59,143	7.65	30,931	4.00	$ 38,664	5.00 %
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	$ 63,176	13.73 %	$ 18,402	4.00 %	N/A	N/A
AuburnBank	59,143	12.97	18,244	4.00	$ 27,365	6.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	$ 68,906	14.98 %	$ 36,803	8.00 %	N/A	N/A
AuburnBank	64,873	14.22	36,487	8.00	$ 45,609	10.00 %
At December 31, 2008:						
Tier 1 Leverage Capital						
Auburn National Bancorporation	$ 63,629	8.75 %	$ 29,101	4.00 %	N/A	N/A
AuburnBank	59,473	8.22	28,929	4.00	$ 36,161	5.00 %
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	$ 63,629	14.23 %	$ 17,881	4.00 %	N/A	N/A
AuburnBank	59,473	13.43	17,718	4.00	$ 26,577	6.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	$ 68,027	15.22 %	$ 35,761	8.00 %	N/A	N/A
AuburnBank	63,871	14.42	35,436	8.00	$ 44,295	10.00 %

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 statutes 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, 2009, the Bank could have declared additional dividends of approximately $6.1 million without prior approval of regulatory authorities. As a result of this limitation, approximately $50.1 million of the Company s investment in the Bank was restricted from transfer in the form of dividends.

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NOTE 19: AUBURN NATIONAL BANCORPORATION (PARENT COMPANY)

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

CONDENSED BALANCE SHEETS

	December 31	
(Dollars in thousands)	**2009**	**2008**
Assets:		
Cash and due from banks	$ 765	$ 855
Investment in bank subsidiary	59,254	60,075
Premises and Equipment	3,474	3,575
Other assets	591	602
Total assets	$ 64,084	$ 65,107
Liabilities:		
Accrued expenses and other liabilities	$ 684	$ 762
Long-term debt	7,217	7,217
Total liabilities	7,901	7,979
Stockholders equity	56,183	57,128
Total liabilities and stockholders equity	$ 64,084	$ 65,107

CONDENSED STATEMENTS OF EARNINGS

	Years ended December 31		
(Dollars in thousands)	**2009**	**2008**	**2007**
Income:			
Dividends from bank subsidiary	$ 3,014	$ 3,136	$ 4,753
Noninterest income	445	307	463
Total income	3,459	3,443	5,216

Expense:			
Interest	236	397	583
Non-interest	587	526	494
Total expense	823	923	1,077
Earnings before income tax benefit and equity in undistributed earnings of bank subsidiary	2,636	2,520	4,139
Income tax benefit	(97)	(214)	(224)
Earnings before equity in undistributed earnings of bank subsidiary	2,733	2,734	4,363
Equity in undistributed (loss) earnings of bank subsidiary	(329)	3,903	2,555
Net earnings	$ 2,404	$ 6,637	$ 6,918

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CONDENSED STATEMENTS OF CASH FLOWS

	Years ended December 31		
(Dollars in thousands)	**2009**	**2008**	**2007**
Cash flows from operating activities:			
Net earnings	$ 2,404	$ 6,637	$ 6,918
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	105	110	116
Loss on sale of premises and equipment		142	
Net decrease (increase) in other assets	11	(38)	91
Net (decrease) increase in other liabilities	(78)	(113)	241
Equity in undistributed loss (earnings) of bank subsidiary	329	(3,903)	(2,555)
Net cash provided by operating activities	2,771	2,835	4,811
Cash flows from investing activities:			
Purchases of premises and equipment	(4)	(6)	(605)
Proceeds from sale of premises and equipment		282	
Net cash provided by (used in)	(4)	276	(605)
Cash flows from financing activities:			
Stock repurchases	(90)	(813)	(1,613)
Proceeds from sale of treasury stock	3	2	
Dividends paid	(2,770)	(2,716)	(2,643)
Net cash used in financing activities	(2,857)	(3,527)	(4,256)
Net change in cash and cash equivalents	(90)	(416)	(50)
Cash and cash equivalents at beginning of period	855	1,271	1,321
Cash and cash equivalents at end of period	$ 765	$ 855	$ 1,271

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 clicking the heading About Us on the Company s website, *www.auburnbank.com*, and then clicking on Corporate Governance. 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, Compensation Discussion and Analysis, Executive Officers, and Compensation Committee Report 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, 2009 the Company had no compensation plans under which equity securities of the Company are authorized for issuance.

The Company s Long Term Incentive Plan expired on May 10, 2004. No new plans have been issued.

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.

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, 2009 and 2008

Consolidated Statements of Earnings for the years ended December 31, 2009, 2008, and 2007

Consolidated Statements of Stockholders Equity and Comprehensive Income for the years ended December 31, 2009, 2008, and 2007

Consolidated Statements of Cash Flows for the years ended December 31, 2009, 2008, and 2007

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)).

10.2. Lease and Equipment Purchase Agreement, dated September 15, 1987 (incorporated by reference from Registrant s Registration Statement on Form SB-2 (File No. 33-86180)).

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, VP, Controller and Chief Financial Officer.

(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.

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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 the 30th day of March, 2010.

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
/S/ E. L. SPENCER, JR.	President, CEO and Chairman of the Board	March 30, 2010
E. L. Spencer, Jr.	(Principal Executive Officer)	
/S/ DAVID A. HEDGES	VP, Controller and Chief Financial Officer	March 30, 2010
David A. Hedges	(Principal Financial and Accounting Officer)	
/S/ C. WAYNE ALDERMAN	Director	March 30, 2010
C. Wayne Alderman		
/S/ TERRY W. ANDRUS	Director	March 30, 2010
Terry W. Andrus		
/S/ J. TUTT BARRETT	Director	March 30, 2010
J. Tutt Barrett		
/S/ ROBERT W. DUMAS	Director	March 30, 2010
Robert W. Dumas		
/S/ J. E. EVANS	Director	March 30, 2010
J. E. Evans		
/S/ WILLIAM F. HAM, JR.	Director	March 30, 2010
William F. Ham, Jr.		

/S/ DAVID E. HOUSEL	Director	March 30, 2010
David E. Housel		
/S/ ANNE M. MAY	Director	March 30, 2010
Anne M. May		
/S/ EDWARD LEE SPENCER, III	Director	March 30, 2010
Edward Lee Spencer, III		
/S/ EMIL F. WRIGHT, JR.	Director	March 30, 2010
Emil F. Wright, Jr.		