

AUBURN NATIONAL BANCORPORATION INC

Form 10-Q

August 14, 2006

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As filed with the Securities and Exchange Commission on August 14, 2006

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

☒ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**  
For the quarterly period ended June 30, 2006

☐ **Transition report pursuant to Section 13 or 15(d) of the Exchange Act**  
For the transition period \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-26486

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**Auburn National Bancorporation, Inc.**

(Exact Name of Registrant as Specified in Its Charter)

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**Delaware**  
(State or other jurisdiction of

incorporation or organization)

**100 N. Gay Street**

**Auburn, Alabama 36830**

**63-0885779**  
(I.R.S. Employer

Identification No.)

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(334) 821-9200

(Address and telephone number of principal executive offices)

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

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

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

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

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

| Class                                   | Outstanding at July 31, 2006 |
|-----------------------------------------|------------------------------|
| Common Stock, \$.01 par value per share | 3,777,647 shares             |

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Condensed Consolidated Balance Sheets

June 30, 2006 and December 31, 2005

(Unaudited)

|                                                                                                                                     | 6/30/2006      | 12/31/2005  |
|-------------------------------------------------------------------------------------------------------------------------------------|----------------|-------------|
| <b>Assets</b>                                                                                                                       |                |             |
| Cash and due from banks                                                                                                             | \$ 15,339,189  | 13,704,096  |
| Federal funds sold                                                                                                                  | 16,105,000     | 10,237,409  |
| Cash and cash equivalents                                                                                                           | 31,444,189     | 23,941,505  |
| Interest-earning deposits with other banks                                                                                          | 1,336,090      | 2,140,856   |
| Investment securities held to maturity (fair value of \$564,939 and \$636,962 at June 30, 2006 and December 31, 2005, respectively) | 564,131        | 633,478     |
| Investment securities available for sale                                                                                            | 290,954,324    | 274,327,424 |
| Loans held for sale                                                                                                                 | 3,224,293      | 1,400,269   |
| Loans                                                                                                                               | 294,320,284    | 282,059,247 |
| Less allowance for loan losses                                                                                                      | (3,987,871)    | (3,843,374) |
| Loans, net                                                                                                                          | 290,332,413    | 278,215,873 |
| Premises and equipment, net                                                                                                         | 2,293,473      | 2,428,619   |
| Rental property, net                                                                                                                | 1,644,324      | 1,236,583   |
| Other assets                                                                                                                        | 28,485,093     | 23,829,154  |
| Total assets                                                                                                                        | \$ 650,278,330 | 608,153,761 |
| <b>Liabilities and Stockholders' Equity</b>                                                                                         |                |             |
| Deposits:                                                                                                                           |                |             |
| Noninterest-bearing                                                                                                                 | \$ 78,489,617  | 70,784,282  |
| Interest-bearing                                                                                                                    | 411,775,335    | 384,211,006 |
| Total deposits                                                                                                                      | 490,264,952    | 454,995,288 |
| Securities sold under agreements to repurchase                                                                                      | 8,518,822      | 1,731,391   |
| Other borrowed funds                                                                                                                | 98,196,131     | 98,205,256  |
| Note payable to Trust                                                                                                               | 7,217,000      | 7,217,000   |
| Accrued expenses and other liabilities                                                                                              | 1,953,252      | 2,050,348   |
| Total liabilities                                                                                                                   | 606,150,157    | 564,199,283 |
| 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                                               | 39,571         | 39,571      |
| Additional paid-in capital                                                                                                          | 3,735,803      | 3,734,425   |
| Retained earnings                                                                                                                   | 49,085,186     | 46,918,896  |

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|                                                                                                              |                |             |
|--------------------------------------------------------------------------------------------------------------|----------------|-------------|
| Accumulated other comprehensive loss, net                                                                    | (5,690,406)    | (3,981,772) |
| Less treasury stock at cost, 174,268 and 162,119 shares at June 30, 2006 and December 31, 2005, respectively | (3,041,981)    | (2,756,642) |
| Total stockholders' equity                                                                                   | 44,128,173     | 43,954,478  |
| Total liabilities and stockholders' equity                                                                   | \$ 650,278,330 | 608,153,761 |

See accompanying notes to condensed consolidated financial statements.

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## Condensed Consolidated Statements of Earnings

For the Three and Six Months Ended June 30, 2006 and 2005

(Unaudited)

|                                                     | Three Months Ended June 30, |           | Six Months Ended June 30, |            |
|-----------------------------------------------------|-----------------------------|-----------|---------------------------|------------|
|                                                     | 2006                        | 2005      | 2006                      | 2005       |
| Interest and dividend income:                       |                             |           |                           |            |
| Loans, including fees                               | \$ 5,303,296                | 4,421,849 | 10,272,359                | 8,564,486  |
| Investment securities:                              |                             |           |                           |            |
| Taxable                                             | 2,791,295                   | 2,380,866 | 5,268,364                 | 4,784,055  |
| Tax-exempt                                          | 522,473                     | 451,834   | 1,038,516                 | 888,938    |
| Federal funds sold                                  | 44,848                      | 59,436    | 172,892                   | 110,986    |
| Interest-earning deposits with other banks          | 6,754                       | 15,584    | 13,586                    | 20,399     |
| Total interest and dividend income                  | 8,668,666                   | 7,329,569 | 16,765,717                | 14,368,864 |
| Interest expense:                                   |                             |           |                           |            |
| Deposits                                            | 3,618,217                   | 2,496,522 | 6,902,178                 | 4,675,590  |
| Securities sold under agreements to repurchase      | 119,361                     | 16,999    | 154,951                   | 32,665     |
| Other borrowings                                    | 1,166,023                   | 1,183,851 | 2,292,072                 | 2,347,138  |
| Total interest expense                              | 4,903,601                   | 3,697,372 | 9,349,201                 | 7,055,393  |
| Net interest income                                 | 3,765,065                   | 3,632,197 | 7,416,516                 | 7,313,471  |
| Provision for loan losses                           | 105,000                     | 150,000   | 210,000                   | 300,000    |
| Net interest income after provision for loan losses | 3,660,065                   | 3,482,197 | 7,206,516                 | 7,013,471  |
| Noninterest income:                                 |                             |           |                           |            |
| Service charges on deposit accounts                 | 349,548                     | 389,120   | 692,094                   | 747,155    |
| Investment securities gains (losses), net           | 11,631                      | (6,005)   | 43,425                    | 7,175      |
| Other                                               | 761,677                     | 1,251,772 | 1,563,752                 | 2,618,108  |
| Total noninterest income                            | 1,122,856                   | 1,634,887 | 2,299,271                 | 3,372,438  |
| Noninterest expense:                                |                             |           |                           |            |
| Salaries and benefits                               | 1,340,396                   | 1,307,330 | 2,781,727                 | 2,723,036  |
| Net occupancy expense                               | 266,863                     | 275,070   | 534,430                   | 557,216    |
| Other                                               | 847,185                     | 1,478,470 | 1,684,022                 | 2,990,565  |
| Total noninterest expense                           | 2,454,444                   | 3,060,870 | 5,000,179                 | 6,270,817  |
| Earnings before income taxes                        | 2,328,477                   | 2,056,214 | 4,505,608                 | 4,115,092  |
| Income tax expense                                  | 595,487                     | 521,681   | 1,128,374                 | 1,001,098  |

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|                                              |    |           |           |           |           |
|----------------------------------------------|----|-----------|-----------|-----------|-----------|
| Net earnings                                 | \$ | 1,732,990 | 1,534,533 | 3,377,234 | 3,113,994 |
| Basic and diluted earnings per share:        | \$ | 0.46      | 0.40      | 0.89      | 0.81      |
| Weighted-average shares outstanding, basic   |    | 3,783,970 | 3,841,965 | 3,785,104 | 3,843,829 |
| Weighted-average shares outstanding, diluted |    | 3,784,441 | 3,842,821 | 3,785,585 | 3,844,726 |

See accompanying notes to condensed consolidated financial statements.

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## Condensed Consolidated Statement of Stockholders' Equity and Comprehensive Income (Loss)

For the Six Months Ended June 30, 2006

(Unaudited)

|                                                                                                                                       | Common stock                   |           |           |                                  |                      | Accumulated<br>other<br>comprehensive | Treasury    |             |
|---------------------------------------------------------------------------------------------------------------------------------------|--------------------------------|-----------|-----------|----------------------------------|----------------------|---------------------------------------|-------------|-------------|
|                                                                                                                                       | Comprehensive<br>income/(loss) | Shares    | Amount    | Additional<br>paid-in<br>capital | Retained<br>earnings | loss                                  | stock       | Total       |
| Balances at December 31,<br>2005                                                                                                      |                                | 3,957,135 | \$ 39,571 | 3,734,425                        | 46,918,896           | (3,981,772)                           | (2,756,642) | 43,954,478  |
| Comprehensive income:                                                                                                                 |                                |           |           |                                  |                      |                                       |             |             |
| Net earnings                                                                                                                          | \$ 3,377,234                   |           |           |                                  | 3,377,234            |                                       |             | 3,377,234   |
| Other comprehensive loss<br>due to change in unrealized<br>loss on investment securities<br>available for sale and<br>derivative, net | (1,708,634)                    |           |           |                                  |                      | (1,708,634)                           |             | (1,708,634) |
| Total comprehensive income                                                                                                            | \$ 1,668,600                   |           |           |                                  |                      |                                       |             |             |
| Cash dividends paid (\$0.32<br>per share)                                                                                             |                                |           |           |                                  | (1,210,944)          |                                       |             | (1,210,944) |
| Purchase of treasury stock<br>(12,349 shares)                                                                                         |                                |           |           |                                  |                      |                                       | (286,639)   | (286,639)   |
| Sale of treasury stock (200<br>shares)                                                                                                |                                |           |           | 1,378                            |                      |                                       | 1,300       | 2,678       |
| Balances at June 30, 2006                                                                                                             |                                | 3,957,135 | \$ 39,571 | 3,735,803                        | 49,085,186           | (5,690,406)                           | (3,041,981) | 44,128,173  |

See accompanying notes to condensed consolidated financial statements.



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## Condensed Consolidated Statements of Cash Flows

For the Six Months Ended June 30, 2006 and 2005

(Unaudited)

|                                                                                     | 2006         | 2005         |
|-------------------------------------------------------------------------------------|--------------|--------------|
| Cash flows from operating activities:                                               |              |              |
| Net earnings                                                                        | \$ 3,377,234 | 3,113,994    |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |              |              |
| Depreciation and amortization                                                       | 176,474      | 228,510      |
| Net amortization of premiums/discounts on investment securities                     | 319,111      | 497,845      |
| Provision for loan losses                                                           | 210,000      | 300,000      |
| Loss on disposal of premises and equipment                                          | 158          |              |
| Investment securities gains                                                         | (43,425)     | (7,175)      |
| Net (increase) decrease in loans held for sale                                      | (1,824,024)  | 118,545      |
| Increase in interest receivable                                                     | (520,232)    | (91,700)     |
| Increase in other assets                                                            | (2,876,263)  | (875,308)    |
| Increase in interest payable                                                        | 167,187      | 191,560      |
| Decrease in accrued expenses and other liabilities                                  | (280,683)    | (1,107,675)  |
| Net cash provided by (used in) operating activities                                 | (1,294,463)  | 2,368,596    |
| Cash flows from investing activities:                                               |              |              |
| Proceeds from sales of investment securities available for sale                     | 9,817,044    | 31,899,543   |
| Proceeds from maturities/calls/paydowns of investment securities held to maturity   | 69,292       | 80,656       |
| Proceeds from maturities/calls/paydowns of investment securities available for sale | 14,636,355   | 19,750,615   |
| Purchases of investment securities available for sale                               | (44,272,653) | (50,085,473) |
| Net increase in loans                                                               | (12,326,540) | (20,252,780) |
| Purchases of premises and equipment                                                 | (36,906)     | (36,042)     |
| Proceeds from the sale of other real estate                                         |              | 72,916       |
| Proceeds from the sale of premises and equipment                                    | 4,494        |              |
| Purchase of rental property                                                         | (451,770)    |              |
| Net decrease (increase) in interest-earning deposits with other banks               | 804,766      | (216,182)    |
| Net cash used in investing activities                                               | (31,755,918) | (18,786,747) |
| Cash flows from financing activities:                                               |              |              |
| Net increase in noninterest-bearing deposits                                        | 7,705,335    | 5,612,406    |
| Net increase in interest-bearing deposits                                           | 27,564,329   | 11,968,144   |
| Net increase (decrease) in securities sold under agreements to repurchase           | 6,787,431    | (5,054,420)  |
| Repayments of other borrowed funds                                                  | (9,125)      | (9,124)      |
| Sale of treasury stock                                                              | 2,678        | 4,540        |
| Purchase of treasury stock                                                          | (286,639)    | (202,496)    |
| Dividends paid                                                                      | (1,210,944)  | (1,114,451)  |
| Net cash provided by financing activities                                           | 40,553,065   | 11,204,599   |
| Net increase (decrease) in cash and cash equivalents                                | 7,502,684    | (5,213,552)  |

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|                                                   |               |            |
|---------------------------------------------------|---------------|------------|
| Cash and cash equivalents at beginning of period  | 23,941,505    | 26,431,412 |
| Cash and cash equivalents at end of period        | \$ 31,444,189 | 21,217,860 |
| Supplemental information on cash payments:        |               |            |
| Interest paid                                     | \$ 9,182,014  | 6,863,832  |
| Income taxes paid                                 | \$ 3,199,439  | 1,625,000  |
| Supplemental information on noncash transactions: |               |            |
| Real estate acquired through foreclosure          | \$ 275,600    | 221,547    |

See accompanying notes to condensed consolidated financial statements.

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

**Notes to the Condensed Consolidated Financial Statements**

**June 30, 2006**

**Note 1- General**

The consolidated financial statements in this report have been prepared in accordance with accounting principles generally accepted in the United States and have not been audited. Accordingly, these financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments necessary to present fairly the financial position and the results of operations for the interim periods have been made. All such adjustments are of a normal recurring nature. The results of operations are not necessarily indicative of the results of operations that Auburn National Bancorporation, Inc. (the Company) may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company's annual report on Form 10-K for the year ended December 31, 2005.

**Note 2- Comprehensive Income**

The primary component of the differences between net income and comprehensive income for the Company is unrealized gains/losses on available for sale securities and derivatives. Total comprehensive income for the three months ended June 30, 2006 was \$248,000 compared to comprehensive loss of \$2,825,000 for the three months ended June 30, 2005. Total comprehensive income for the six months ended June 30, 2006 was \$1,669,000 compared to comprehensive loss of \$2,010,000 for the six months ended June 30, 2005.

**Note 3 Pending and New Accounting Pronouncements**

In December 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2005), Share-Based Payment (SFAS No. 123R), which revised SFAS No. 123, Accounting for Stock-Based Compensation. This statement supercedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). SFAS No. 123R addresses the accounting for share-based payment transactions with employees and other third parties, eliminates the ability to account for share-based compensation transactions using APB 25 and requires that the compensation costs relating to such transactions be recognized in the consolidated statement of earnings. The Company adopted SFAS No. 123R effective January 1, 2006, which did not have a material impact on the consolidated balance sheets or statements of earnings for the Company as all options outstanding were fully vested at that date.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140. SFAS No. 156 amends SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, with respect to the accounting for separately recognized servicing assets and liabilities. SFAS No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like accounting. SFAS No. 156 is effective as of the beginning of the first fiscal year that begins after September 15, 2006. The Company does not expect the adoption of SFAS No. 156 to have a material impact on the consolidated balance sheets or statements of earnings of the Company.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, or expected to be taken in a tax return, and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently assessing the impact, if any, that the adoption of this Interpretation will have on its financial statements.

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

The following discussion and analysis is designed to provide a better understanding of various factors related to the results of operations and financial condition of the Company and its wholly-owned subsidiary, AuburnBank (the "Bank"). This discussion is intended to supplement and highlight information contained in the accompanying unaudited consolidated financial statements for the three and six months ended June 30, 2006 and June 30, 2005.

Certain of the statements made herein under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations," and elsewhere, including information incorporated herein by reference to other documents, are forward-looking statements within the meaning of, and subject to the protections of Section 27A of the Securities Act of 1933, as amended, (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions, and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause our actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements.

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

future economic and business conditions;

government monetary and fiscal policies;

the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values of loan collateral, securities, and interest sensitive assets and liabilities;

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

credit risks;

uncertainties regarding assumptions underlying the establishment of allowance for possible loan losses and other estimates;

uncertainties regarding mergers and acquisitions, including, without limitation, the related costs and time of integrating operations as part of these transactions and the failure to achieve expected gains, revenue growth and/or expense savings from such transactions;

changes in laws and regulations, including tax, banking and securities laws and regulations;

changes in accounting policies, rules and practices;

changes in technology or products, which may be more difficult or 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 and economic confidence; and

other factors and information in this report and other filings that we make with the SEC under the Exchange Act, including our Form 10-K for the year ended December 31, 2005 and subsequent quarterly and current reports. See Part II, Item 1A, Risk Factors.

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

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### **Business**

Auburn National Bancorporation, Inc. (the Company) is a one-bank holding company established in 1984, and incorporated under the laws of the State of Delaware. AuburnBank (the Bank), the Company's principal subsidiary, is an Alabama state-chartered bank that is a member of the Federal Reserve System and has operated continuously since 1907. Both the Company and the Bank are headquartered in Auburn, Alabama. The Bank conducts its business in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, Hurtsboro and Notasulga, Alabama. In-store branches are located in the Auburn Kroger store, as well as Wal-Mart SuperCenter stores in Auburn, Opelika and Phenix City, Alabama. Mortgage loan offices are located in Phenix City, Valley and Gulf Shores, Alabama. A new in-store branch is planned to open in 2007 at the Kroger supermarket to be located in the Tiger Town shopping center in Opelika, Alabama.

### **Summary**

Net income of \$1,733,000 for the quarter ended June 30, 2006 represented an increase of \$198,000 (12.9%) from the Company's net income of \$1,535,000 for the same period of 2005. Basic and diluted net earnings per share increased \$0.06 (15.0%) to \$0.46 during the second quarter of 2006 from \$0.40 for the second quarter of 2005. Net income increased \$263,000 (8.4%) to \$3,377,000 for the six months ended June 30, 2006 compared to \$3,114,000 for the same period of 2005. Basic and diluted net earnings per share increased \$0.08 (9.9%) to \$0.89 during the six months ended June 30, 2006 from \$0.81 for the six months ended June 30, 2005. The increase in the Company's net income during the six months ended June 30, 2006 compared to the same period of 2005 was primarily due to an increase in net interest income and a decrease in noninterest expense and provision for loan losses. This was partially offset by a decrease in noninterest income. The net yield on total interest-earning assets decreased to 2.75% for the six months ended June 30, 2006 from 2.80% for the same period of 2005. The decrease in the net yield on interest-earning assets is due to a larger increase in the cost of funds compared to the increase in yield on interest-earning assets. See the CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSES AND YIELDS/RATES table.

Total assets of \$650,278,000 at June 30, 2006 represented an increase of \$42,124,000 (6.9%) over total assets of \$608,154,000 at December 31, 2005. This increase resulted primarily from an increase of \$12,261,000 in loans and an increase of \$16,627,000 in investment securities available for sale. The primary sources of loans and investment securities available for sale were an increase in total deposits of \$35,270,000.

### **Critical Accounting Policies**

The accounting and financial policies of the Company conform to accounting principles generally accepted in the United States and to general practices within the banking industry. The allowance for loan losses is an accounting policy applied by the Company which is deemed critical. Critical accounting policies are defined as policies which are important to the portrayal of the Company's financial condition and results of operations, and that require management's most difficult, subjective or complex judgments. These estimates and judgments involve significant uncertainties, and are susceptible to change. If different conditions exist or occur, and depending upon the magnitude of the changes, then our actual financial condition and financial results could differ significantly. See ALLOWANCE FOR LOAN LOSSES AND RISK ELEMENTS.

For a more detailed discussion on these critical accounting policies, see CRITICAL ACCOUNTING POLICIES on page 22 of the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

### **Financial Condition**

#### **Investment Securities and Federal Funds Sold**

Investment securities held to maturity were \$564,000 at June 30, 2006 and \$633,000 at December 31, 2005. This decrease of \$69,000 (10.9%) was primarily the result of scheduled paydowns and calls of principal amounts. These funds were reinvested in investment securities available for sale.

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Investment securities available for sale increased \$16,627,000 (6.1%) to \$290,954,000 at June 30, 2006 from \$274,327,000 at December 31, 2005. This increase is a result of purchases of \$22,976,000 in U.S. agency securities, \$9,133,000 in mortgage-backed securities, \$7,850,000 in collateralized mortgage obligations, \$3,257,000 in state and political subdivision securities and \$1,057,000 in corporate securities. These purchases were offset by \$14,636,000 in scheduled paydowns, maturities and issuer calls of principal amounts. In addition, \$3,769,000 of collateralized mortgage obligations and \$6,048,000 of state and political subdivision securities were sold in the first six months of 2006.

Federal funds sold increased to \$16,105,000 at June 30, 2006 from \$10,237,000 at December 31, 2005. This reflects normal activity in the Bank's funds management efforts.

## Loans

Total loans of \$294,320,000 at June 30, 2006 reflected an increase of \$12,261,000 (4.3%) compared to the total loans of \$282,059,000 at December 31, 2005. The Bank primarily experienced growth in commercial and residential real estate mortgage loans and commercial, financial and agricultural loans during the six months ended June 30, 2006. Three loan categories represented the majority of the loan portfolio with commercial real estate mortgage loans consisting of 53.43%, residential real estate mortgage loans consisting of 21.27% and commercial, financial and agricultural loans consisting of 16.74%, of the Bank's total loans at June 30, 2006. The net yield on loans was 7.26% for the six months ended June 30, 2006 compared to 6.44% for the six months ended June 30, 2005 primarily due to an increase in interest rates. See the

CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSE AND YIELDS/RATES table.

## Allowance for Loan Losses and Risk Elements

The allowance for loan losses reflects management's assessments and estimates of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. Management reviews the components of the loan portfolio in order to estimate the appropriate provision required to maintain the allowance at a level believed adequate in relation to losses inherent in the loan portfolio. In assessing the allowance, management reviews the size, quality and risk of loans in the portfolio. Management also considers such factors as the Bank's loan loss experience, the amount of past due and nonperforming loans, specific known risks, the status, amounts, and values of nonperforming assets (including loans), underlying collateral values securing loans, current and anticipated economic conditions, and other factors, including developments anticipated by management with respect to various credits which management believes affects the allowance for loan losses.

The Company's policy generally is to place a loan on nonaccrual status when it is contractually past due 90 days or more in payment of principal or interest. A loan may be placed on nonaccrual status at an earlier date if concerns exist as to the ultimate collectability of principal or interest. At the time a loan is placed on nonaccrual status, interest previously accrued but not collected is reversed and charged against current earnings. Loans that are contractually past due 90 days or more, which are well secured and in the process of collection, are generally not placed on nonaccrual status.

The table below summarizes the changes in the allowance for loan losses for the six months ended June 30, 2006 and 2005 and the year ended December 31, 2005.

|                                            | Six months ended | Six months ended |              |
|--------------------------------------------|------------------|------------------|--------------|
|                                            | June 30,         | June 30,         | Year ended   |
|                                            | 2006             | 2005             | December 31, |
|                                            |                  | (In thousands)   | 2005         |
| Balance at beginning of period, January 1, | \$ 3,843         | \$ 3,456         | \$ 3,456     |
| Charge-offs                                | 93               | 201              | 356          |
| Recoveries                                 | 28               | 213              | 258          |
| Net charge-offs (recoveries)               | 65               | (12)             | 98           |
| Provision for loan losses                  | 210              | 300              | 485          |
| Ending balance                             | \$ 3,988         | \$ 3,768         | \$ 3,843     |





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The allowance for loan losses was \$3,988,000 at June 30, 2006 compared to \$3,843,000 at December 31, 2005. Management believes that the current level of allowance for loan losses (1.35% of total outstanding loans at June 30, 2006) is adequate to absorb anticipated losses identified in the portfolio at June 30, 2006. No assurance can be given, however, that adverse economic circumstances or other events, including additional loan review or examination findings or changes in borrowers' financial conditions, will not result in increased losses in the Bank's loan portfolio or in additional provision to the allowance for loan losses.

During the first six months of 2006, the Bank made \$210,000 in provisions to the allowance for loan losses based on management's assessment of the credit quality of the loan portfolio. For the six months ended June 30, 2006, the Bank had charge-offs of \$93,000 and recoveries of \$28,000.

Nonperforming assets, comprised of nonaccrual loans, other nonperforming assets, and accruing loans 90 days or more past due, were \$193,000 at June 30, 2006, an increase of 78.7% from \$108,000 at December 31, 2005. This increase is mainly due to an increase in other real estate owned. If nonaccrual loans had performed in accordance with their original contractual terms, interest income would have increased by approximately \$2,000 for the six months ended June 30, 2006.

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

|                                                                                                    | June 30,<br>2006 | December 31,<br>2005 |
|----------------------------------------------------------------------------------------------------|------------------|----------------------|
|                                                                                                    | (In thousands)   |                      |
| Nonaccrual loans                                                                                   | \$ 19            | 108                  |
| Other nonperforming assets (primarily other real estate owned)                                     | 174              |                      |
| Accruing loans 90 days or more past due                                                            |                  |                      |
| Total nonperforming assets                                                                         | \$ 193           | 108                  |
| Ratio of allowance for loan losses as a percent of total loans outstanding                         | 1.35%            | 1.36%                |
| Ratio of allowance for loan losses as a percent of nonaccrual loans and other nonperforming assets | 2,066.33%        | 3,558.33%            |

Potential problem loans consist of those loans where management has serious doubt as to the borrower's ability to comply with the contractual loan repayment terms. At June 30, 2006, 62 loans totaling \$5,320,000, or 1.8% of total loans outstanding, net of unearned income, were considered potential problem loans compared to 65 loans totaling \$5,365,000, or 1.9% of total loans outstanding, net of unearned income, at December 31, 2005. At June 30, 2006 and December 31, 2005 the Company had no impaired loans.

**Deposits**

Total deposits increased \$35,270,000 (7.8%) to \$490,265,000 at June 30, 2006, compared to \$454,995,000 at December 31, 2005. Noninterest-bearing deposits increased \$7,706,000 (10.9%) during the first six months of 2006, while total interest-bearing deposits increased \$27,564,000 (7.2%) to \$411,775,000 at June 30, 2006 from \$384,211,000 at December 31, 2005. The increase in noninterest-bearing deposits is due primarily to an increase in regular demand deposit accounts. During the first six months of 2006, the Bank experienced an increase in certificates of deposit over \$100,000 of \$14,236,000 (14.8%) and money market accounts of \$14,905,000 (12.9%). The Company considers the shifts in the deposit mix to be within the normal course of business and in line with the Bank's funding strategy and changes in customer preferences for interest-bearing deposits as market rates have increased. The average rate paid on interest-bearing deposits was 3.53% for the six months ended June 30, 2006 compared to 2.54% for the same period of 2005 due to an increase in interest rates. See the CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSE AND YIELDS/RATES table.

**Table of Contents****Capital Resources and Liquidity**

The Company's consolidated stockholders' equity was \$44,128,000 at June 30, 2006, compared to \$43,954,000 at December 31, 2005. This represents an increase of \$174,000 (0.4%) during the first six months of 2006 primarily due to net earnings. Net earnings for the first six months of 2006 were \$3,377,000 compared to \$3,114,000 for the same period of 2005. In addition, the Company's accumulated other comprehensive loss was \$5,690,000 at June 30, 2006 compared to an accumulated other comprehensive loss of \$3,982,000 at December 31, 2005. The increase in the accumulated other comprehensive loss is due to a decrease in the fair value of investment securities available for sale. During the first six months of 2006, cash dividends of \$1,211,000 or \$0.32 per share, were declared on the Company's common stock.

Certain financial ratios for the Company are presented in the following table:

|                          |            | June 30, 2006 | December 31, 2005 |
|--------------------------|------------|---------------|-------------------|
| Return on average assets | annualized | 1.09%         | 1.08%             |
| Return on average equity | annualized | 15.51%        | 14.26%            |

The Company's Tier 1 leverage ratio was 9.07%, Tier 1 risk-based capital ratio was 15.90% and Total risk-based capital ratio was 14.86% at June 30, 2006. 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 believes it is well capitalized.

The primary source of liquidity during the first six months of 2006 was deposit growth. The Company used these funds to fund loan growth and purchases of investment securities available for sale. Under the advance program with Federal Home Loan Bank of Atlanta (FHLB-Atlanta), the Bank had outstanding advances totaling approximately \$98,196,000 at June 30, 2006, under total FHLB-Atlanta facilities of 30% of the Bank's total assets or \$194,390,000 as of June 30, 2006.

Net cash used in operating activities of \$1,294,000 for the six months ended June 30, 2006 consisted primarily of an increase in loans held for sale and other assets offset by net earnings. Net cash used in investing activities of \$31,756,000 principally resulted from investment securities purchases of \$44,273,000 and an increase in loans of \$12,327,000. This is offset by proceeds from maturities, calls and paydowns of investment securities available for sale and held to maturity of \$14,636,000 and proceeds from sales of investment securities available for sale of \$9,817,000. The \$40,533,000 in net cash provided by financing activities resulted primarily from an increase of \$27,564,000 in interest-bearing deposits, an increase of \$7,705,000 in non-interest bearing deposits and an increase in securities sold under agreements to repurchase of \$6,787,000.

**Note Payable to Trust**

The Company owns all the common securities of a Delaware statutory trust, Auburn National Bancorporation Capital Trust I. This unconsolidated subsidiary issued approximately \$7,000,000 million in trust preferred trust securities, guaranteed by the Company on a junior subordinated basis. The Company obtained these proceeds through a note payable to the trust in the form of junior subordinated debentures. As of June 30, 2006, \$7,000,000 of the \$7,217,000 note payable to trust was classified as Tier 1 Capital for regulatory purposes. For regulatory purposes, the trust preferred securities are currently included in Tier 1 Capital so long as it does not exceed 25% of total Tier 1 capital. The Federal Reserve's new 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..

**Off-Balance Sheet Arrangements**

The Company is a party to 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 instruments involve elements of credit risk in excess of the amounts recognized in the consolidated financial statements.

The Company's exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and entering into conditional obligations as it does for on-balance sheet instruments.



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The financial instruments with contract amounts which represent credit risk as of June 30, 2006 are as follows:

|                              |               |
|------------------------------|---------------|
| Commitments to extend credit | \$ 49,453,000 |
| Standby letters of credit    | 11,283,000    |

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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. Most standby letters of credit expire within one year, but may be renewed. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitment facilities to customers. The Company may hold various assets as collateral supporting those commitments, where it determines that collateral for these obligations is appropriate.

**Interest Rate Sensitivity Management**

At June 30, 2006, interest sensitive assets that reprice or mature within the next 12 months were \$255,454,000 compared to interest sensitive liabilities that reprice or mature within the same time frame totaling \$328,757,000. The cumulative GAP position (the difference between interest sensitive assets and interest sensitive liabilities) of a negative \$73,303,000 resulted in a GAP ratio (calculated as interest sensitive assets divided by interest sensitive liabilities) of 0.78%. This compares to a twelve month cumulative GAP position at December 31, 2005, of a negative \$32,496,000 and a GAP ratio of 0.88%. A negative GAP position indicates that the Company has more interest-bearing liabilities than interest-earning assets that reprice within the period measured, and that net interest income may be adversely affected in a rising rate environment as rates earned on interest-earning assets rise more slowly than rates paid on interest-bearing liabilities. A positive GAP position indicates that the Company has more interest-earning assets than interest-bearing liabilities that reprice within the period measured. The Bank's Asset/Liability Management Committee (ALCO) is charged with the responsibility of managing, to the degree prudently possible, the Company's exposure to interest rate risk, while attempting to provide earnings enhancement opportunities. The Bank's ALCO realizes that GAP is limited in scope since it does not capture all the options or repricing opportunities in the balance sheet. Therefore, ALCO places its emphasis on Income at Risk and Economic Value of Equity measurements. Based on alternative interest rate scenarios used by the Company in modeling for asset/liability planning purposes, the GAP position at June 30, 2006 and various assumptions and estimates, the Company's asset/liability model predicts that the changes in the Company's net interest income would be less than 10.0% when rates are gradually increased or decrease 200 basis points over 12 months. Economic Value of Equity would not change more than the target 25% if rates were shocked up and down 2%. Such estimates and predictions are forecasts which may or may not be realized. See ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

**Results of Operations****Net Income**

Net income increased \$198,000 (12.9%) to \$1,733,000 for the three month period ended June 30, 2006, compared to \$1,535,000 for the same period of 2005. Basic and diluted net earnings per share were \$0.46 and \$0.40 for the second quarters of 2006 and 2005, respectively. Net income increased \$263,000 (8.4%) to \$3,377,000 for the six month period ended June 30, 2006 compared to \$3,114,000 for the same period of 2005. During the six month period ended June 30, 2006 compared to the same period of 2005, the Company experienced an increase in net interest income and a decrease in noninterest expense and provision for loan losses. This was offset by a decrease in noninterest income.

**Net Interest Income**

Net interest income was \$3,765,000 for the second quarter of 2006, an increase of \$133,000 (3.7%) from \$3,632,000 for the same period of 2005. Net interest income increased \$104,000 (1.4%) to \$7,417,000 for the six months ended June 30, 2006, compared to \$7,313,000 for the six months ended June 30, 2005. The increase in net interest income

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for the six month period ending June 30, 2006 resulted primarily from an increase in the average volume in interest-earning assets offset by a decrease in the net yield on total interest earning assets of 5 basis points to 2.75%. Through the second quarter of 2006, the Company's GAP position was more liability sensitive to changes in interest rates. The Company continues to regularly review and manage its asset/liability position in an effort to manage the negative effects of changing rates. See the CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSE AND YIELDS/RATES table.

### **Interest and Dividend Income**

Interest income is a function of the volume of interest earning assets and their related yields. Interest and dividend income was \$8,669,000 and \$7,330,000 for the three months ended June 30, 2006 and 2005, respectively. This represents an increase of \$1,339,000 (18.3%) for the second quarter of 2006 compared to the second quarter of 2005. For the six months ended June 30, 2006, interest and dividend income was \$16,766,000, an increase of \$2,397,000 (16.7%) compared to \$14,369,000 for the same period of 2005. This change for the first six months of 2006 resulted as the Company's yield on interest-earning assets increased 64 basis points while the average volume of interest-earning assets outstanding increased by approximately \$23,000,000 (4.1%) over the same period of 2005. See the CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSE AND YIELDS/RATES table.

Loans are the main component of the Bank's earning assets. Interest and fees on loans were \$5,303,000 and \$4,422,000 for the second quarters of 2006 and 2005, respectively. This reflects an increase of \$881,000 (19.9%) during the three months ended June 30, 2006 over the same period of 2005. For the six month period ended June 30, 2006, interest and fees on loans increased \$1,708,000 (19.9%) to \$10,272,000 from \$8,564,000 for the same period of 2005. The average volume of loans increased \$17,122,000 (6.4%) for the six months ended June 30, 2006 compared to the same period for 2005, while the Company's yield on loans also increased by 82 basis points resulting in the increase in interest and fees on loans for the six months ended June 30, 2006 compared to the same period for 2005.

For the three month period ended June 30, 2006, interest income on investment securities increased \$480,000 (16.9%) to \$3,313,000 from \$2,833,000 for the same period of 2005. Interest income on investment securities for the six month period ended June 30, 2006, increased \$634,000 (11.2%) to \$6,307,000 from \$5,673,000 for the same period of 2005. The Company's average volume of investment securities increased by \$7,390,000 (2.6%) for the first six months of 2006, compared to the same period of 2005, while the net yield on these average balances also increased by 38 basis points. See the CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSE AND YIELDS/RATES table.

### **Interest Expense**

Total interest expense increased \$1,207,000 (32.6%) to \$4,904,000 for the second quarter of 2006 compared to \$3,697,000 for the same period of 2005. Total interest expense increased \$2,294,000 (32.5%) to \$9,349,000 from \$7,055,000 for the six months ended June 30, 2006 and 2005, respectively. This change was due to an increase of 76 basis points in the rates paid on those liabilities during the first six months of 2006 compared to the same period of 2005 and a 5.5% increase in the Company's average volume of interest-bearing liabilities. See the CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSE AND YIELDS/RATES table.

Interest on deposits, the primary component of total interest expense, increased \$1,121,000 (44.9%) to \$3,618,000 for the second quarter of 2006 compared to \$2,497,000 for the same period of 2005. Interest on deposits was \$6,902,000 and \$4,676,000 for the six months ended June 30, 2006 and 2005, respectively. The increase for the six month period ended June 30, 2006 is due to a 99 basis point increase in the rate paid on interest-bearing deposits and a 6.1% increase in the average volume of such deposits.

Interest expense on other borrowings, was \$1,166,000 for the second quarter of 2006 and \$1,184,000 for the same period of 2005. This represents a decrease of \$18,000 (1.5%). For the six months ended June 30, 2006, interest expense on borrowed funds decreased \$55,000 (2.3%) to \$2,292,000 from \$2,347,000 for the same period of 2005. This decrease for the six month period ended June 30, 2006 is mainly due to a 10 basis point decrease in the rate paid on other borrowed funds. The decrease in the rate paid on other borrowed funds resulted from a restructuring of several FHLB advances in the third quarter of 2005.

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### **Provision for Loan Losses**

The provision for loan losses is based on management's assessments and estimates of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The provision for loan losses was \$210,000 and \$300,000 for the six months ended June 30, 2006 and 2005, respectively. Despite loan growth, the provision for loan losses decreased for the six month period ended June 30, 2006 compared to the same period of 2005 due to management's judgment and estimates related to the size of the allowance for loan losses in relation to the credit quality and performance of the loan portfolio during these periods. This improved credit quality and performance resulted from a decrease in nonperforming assets. See **ALLOWANCE FOR LOAN LOSS AND RISK ELEMENTS**.

### **Noninterest Income**

Noninterest income decreased \$512,000 (31.3%) to \$1,123,000 for the second quarter of 2006 from \$1,635,000 for the same period of 2005. Noninterest income was \$2,299,000 and \$3,372,000 for the six months ended June 30, 2006 and 2005, respectively. This decrease is mainly due to a decrease in other noninterest income.

Other noninterest income decreased \$490,000 (39.1%) to \$762,000 for the second quarter of 2006 from \$1,252,000 for the same period of 2005. Other noninterest income was \$1,564,000 and \$2,618,000 for the six months ended June 30, 2006 and 2005, respectively. This represents a decrease of \$1,054,000 (40.3%) for the six month period ended June 30, 2006 compared to the same period of 2005. This decrease was mainly due to a decrease in MasterCard/VISA discounts and fees due to the Company moving its MasterCard/VISA merchant processing to a third party in mid 2005.

### **Noninterest Expense**

Total noninterest expense was \$2,454,000 and \$3,061,000 for the second quarters of 2006 and 2005, respectively, representing a decrease of \$607,000 (19.8%). For the six months ended June 30, 2006, total noninterest expense decreased \$1,271,000 (20.3%) to \$5,000,000 from \$6,271,000 for the same period of 2005. This decrease was mainly due to a decrease in other noninterest expense.

For the second quarter of 2006, other noninterest expense decreased \$631,000 (42.7%) to \$847,000 from \$1,478,000 for the second quarter of 2005. Other noninterest expense was \$1,684,000 and \$2,991,000 for the six months ended June 30, 2006 and 2005, respectively. This decrease is primarily due to a decrease in MasterCard/VISA processing expense as a result of the Company moving its MasterCard/VISA processing to a third party in mid 2005 as mentioned above.

### **Income Taxes**

Income tax expense was \$595,000 and \$522,000 for the second quarters of 2006 and 2005, respectively representing an increase of \$73,000 (14.0%). For the six months ended June 30, 2006, income tax expense increased \$127,000 (12.7%) to \$1,128,000 from \$1,001,000 for the six months ended June 30, 2005. These levels represent an effective tax rate on pre-tax earnings of 25.0% for the six months ended June 30, 2006 and 24.3% for the same period of 2005. The increase in effective tax rate is mainly due to a decrease in earnings on bank-owned life insurance and an overall increase in earnings before income taxes compared to the same period last year.

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

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

**Table of Contents****AUBURN NATIONAL BANCORPORATION, INC. & SUBSIDIARY****Consolidated Average Balances, Interest Income/Expense and Yields/Rates****Taxable Equivalent Basis**

|                                                                            | Six Months Ended June 30, |                 |       |                        |                 |       |
|----------------------------------------------------------------------------|---------------------------|-----------------|-------|------------------------|-----------------|-------|
|                                                                            | 2006                      |                 |       | 2005                   |                 |       |
|                                                                            | Average                   | Yield/          |       | Average                | Yield/          |       |
|                                                                            | Balance                   | Interest        | Rate  | Balance                | Interest        | Rate  |
|                                                                            | (Dollars in thousands)    |                 |       | (Dollars in thousands) |                 |       |
| <b><u>ASSETS</u></b>                                                       |                           |                 |       |                        |                 |       |
| Interest-earning assets:                                                   |                           |                 |       |                        |                 |       |
| Loans, net of unearned income (1)                                          | \$ 285,437                | 10,272          | 7.26% | 268,315                | 8,565           | 6.44% |
| Investment securities:                                                     |                           |                 |       |                        |                 |       |
| Taxable                                                                    | 238,914                   | 5,268           | 4.45% | 238,252                | 4,784           | 4.05% |
| Tax-exempt (2)                                                             | 49,669                    | 1,574           | 6.39% | 42,941                 | 1,346           | 6.32% |
| Total investment securities                                                | 288,583                   | 6,842           | 4.78% | 281,193                | 6,130           | 4.40% |
| Federal funds sold                                                         | 7,588                     | 173             | 4.60% | 8,227                  | 111             | 2.72% |
| Interest-earning deposits with other banks                                 | 638                       | 14              | 4.43% | 1,512                  | 20              | 2.67% |
| Total interest-earning assets                                              | 582,246                   | 17,301          | 5.99% | 559,247                | 14,826          | 5.35% |
| Allowance for loan losses                                                  | (3,913)                   |                 |       | (3,651)                |                 |       |
| Cash and due from banks                                                    | 13,200                    |                 |       | 11,818                 |                 |       |
| Premises and equipment                                                     | 2,367                     |                 |       | 2,625                  |                 |       |
| Rental property, net                                                       | 1,531                     |                 |       | 1,323                  |                 |       |
| Other assets                                                               | 26,463                    |                 |       | 22,626                 |                 |       |
| Total assets                                                               | <b>\$ 621,894</b>         |                 |       | <b>593,988</b>         |                 |       |
| <b><u>LIABILITIES &amp; STOCKHOLDERS' EQUITY</u></b>                       |                           |                 |       |                        |                 |       |
| Interest-bearing liabilities:                                              |                           |                 |       |                        |                 |       |
| Deposits:                                                                  |                           |                 |       |                        |                 |       |
| NOW                                                                        | \$ 69,705                 | 879             | 2.54% | 68,972                 | 557             | 1.63% |
| Savings and money market                                                   | 141,305                   | 2,479           | 3.54% | 115,768                | 1,133           | 1.97% |
| Certificates of deposits less than \$100,000                               | 85,323                    | 1,811           | 4.28% | 87,340                 | 1,564           | 3.61% |
| Certificates of deposits and other time deposits of \$100,000 or more      | 97,959                    | 1,733           | 3.57% | 99,590                 | 1,421           | 2.88% |
| Total interest-bearing deposits                                            | 394,292                   | 6,902           | 3.53% | 371,670                | 4,675           | 2.54% |
| Federal funds purchased and securities sold under agreements to repurchase | 6,473                     | 155             | 4.83% | 2,402                  | 33              | 2.77% |
| Other borrowed funds                                                       | 105,218                   | 2,292           | 4.39% | 105,435                | 2,347           | 4.49% |
| Total interest-bearing liabilities                                         | 505,983                   | 9,349           | 3.73% | 479,507                | 7,055           | 2.97% |
| Noninterest-bearing deposits                                               | 68,157                    |                 |       | 66,881                 |                 |       |
| Accrued expenses and other liabilities                                     | 4,218                     |                 |       | 2,839                  |                 |       |
| Stockholders' equity                                                       | 43,536                    |                 |       | 44,761                 |                 |       |
| Total liabilities and stockholders' equity                                 | <b>\$ 621,894</b>         |                 |       | <b>593,988</b>         |                 |       |
| Net interest income                                                        |                           | <b>\$ 7,952</b> |       |                        | <b>\$ 7,771</b> |       |

|                                            |       |       |
|--------------------------------------------|-------|-------|
| Net yield on total interest-earning assets | 2.75% | 2.80% |
|--------------------------------------------|-------|-------|

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- (1) 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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### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company's interest rate risk remained slightly liability sensitive during the second quarter of 2006. In fact, with a potential income variance of less than 2% the company is almost has neutral interest rate risk.

The Company models economic value of equity as a measure of market risk. As of December 2005, economic value of equity would increase 2.36% if rates decrease 200 basis points and decrease 0.95% if rates increase 200 basis points. As of June 2006, if rates decrease 200 basis points, economic value of equity would increase 10.95% and, if rates increase 200 basis points, economic value of equity would decrease 23.78%.

The Company became slightly less liability-sensitive for a 12 month forecast. The Company's model projection for the next 12 months reflects greater volatility in assets while liabilities remain virtually unchanged. This is primarily due to a greater volume of variable rate loans and fed funds sold along with a LIBOR indexed deposits reaching a cap. However, these benefits are offset by certain convertible FHLB advances becoming variable. The Company measures its exposure to interest risk by modeling a 200 (+ and -) basis point ramp in interest rates. Given these conditions, the Company's modeling projects that net interest income could decrease by 0.50% given a ramp up in interest rates of 200 basis points. For a ramp down in interest rates of 200 basis points, the modeling projects the Company's net interest income could increase by 1.79%. In December, the exposure in a ramp down scenario was 2.36% and the ramp up exposure was (1.38%). The Company recognizes there is uncertainty concerning the direction of future interest rates but believes that the risk of rising interest rates is minimal. As the Company does not consider this change in market sensitivity to be significant, the market rate table, as shown in the Company's Annual Report on Form 10-K for the year ended December 31, 2005, has not been updated in this filing.

### **ITEM 4. CONTROLS AND PROCEDURES**

As of June 30, 2006, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ( CEO ) and Director of Financial Operations ( DFO ), of the effectiveness of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and DFO, 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 CEO and DFO, as appropriate, to allow timely decisions regarding disclosure.

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.

**Table of Contents****PART II OTHER INFORMATION****ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not only the risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.****ISSUER PURCHASES OF EQUITY SECURITIES<sup>1</sup>**

| Period  |          | Total Number of<br>Shares (or Units)<br>Purchased<br>(Dollars in thousands except share data) | Average Price Paid<br>per Share (or<br>Unit) | Total Number of Shares<br>(or Units) Purchased as<br>Part of Publicly<br>Announced Plans or<br>Programs | Maximum Number (or<br>Approximate Dollar Value) of<br>Shares (or Units)<br>that May<br>Yet Be<br>Purchased Under<br>the<br>Plans or<br>Programs |
|---------|----------|-----------------------------------------------------------------------------------------------|----------------------------------------------|---------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------|
| April 1 | April 30 | 535                                                                                           | \$ 23.78                                     | N/A                                                                                                     | \$ 0                                                                                                                                            |
| May 1   | May 31   | 134                                                                                           | \$ 23.65                                     | N/A                                                                                                     | \$ 0                                                                                                                                            |
| June 1  | June 30  | 1,200                                                                                         | \$ 23.93                                     | N/A                                                                                                     | \$ 0                                                                                                                                            |
| Total   |          | 1,869                                                                                         | \$ 23.87                                     | N/A                                                                                                     | \$ 0                                                                                                                                            |

<sup>1</sup> A total of 1,869 shares were purchased in privately negotiated transactions.

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

The Annual Meeting of Shareholders of the Company was held at the AuburnBank Center in Auburn, Alabama, on Tuesday, May 9, 2006, at 3:00 p.m. This meeting was held for the purpose of considering the election of ten directors to the Board of Directors to serve one-year terms expiring at the Company's 2007 Annual Meeting of Shareholders and until their successors have been elected and qualified.

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

|                     | Votes cast for |                                     |
|---------------------|----------------|-------------------------------------|
|                     | Election       | Votes cast to<br>Withhold Authority |
| E.L. Spencer, Jr.   | 3,183,588      | 2,930                               |
| J.E. Evans          | 3,162,319      | 24,199                              |
| Emil F. Wright, Jr. | 3,162,319      | 24,199                              |
| Terry Andrus        | 3,141,064      | 45,454                              |
| Anne M. May         | 3,162,319      | 24,199                              |
| Robert W. Dumas     | 3,162,319      | 24,199                              |
| David E. Housel     | 3,162,038      | 24,480                              |
| William F. Ham, Jr. | 3,183,588      | 2,930                               |

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|                        |           |        |
|------------------------|-----------|--------|
| Edward Lee Spencer III | 3,162,319 | 24,199 |
| C. Wayne Alderman      | 3,162,319 | 24,199 |

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**ITEM 6. EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                                                                                                                                                                                         |
|---------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1                       | Certificate of Incorporation of Auburn National Bancorporation, Inc. and all amendments thereto.*                                                                                                                                          |
| 3.2                       | Bylaws of Auburn National Bancorporation, Inc. **                                                                                                                                                                                          |
| 31.1                      | Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board. |
| 31.2                      | Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by C. Wayne Alderman, Director of Financial Operations.                             |
| 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 C. Wayne Alderman, Director of Financial Operations.***                                                         |

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\* Incorporated by reference from Registrant's Form 10-Q dated June 30, 2002.

\*\* Incorporated by reference from Registrant's Form 8-K dated April 13, 2005.

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

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SIGNATURES

In accordance with the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AUBURN NATIONAL BANCORPORATION, INC.  
(Registrant)

Date: August 14, 2006

By: /s/ E. L. Spencer, Jr.  
E. L. Spencer, Jr.  
President, Chief Executive  
Officer and Chairman of the Board

Date: August 14, 2006

By: /s/ C. Wayne Alderman  
C. Wayne Alderman  
Director of Financial Operations