

Alpena Banking Corporation



2006 Annual Report





**ALPENA BANKING
CORPORATION/
BANK OF ALPENA**

**Board of Directors
December 31, 2006**

Kenneth Cordes

Richard Crittenden

Kevin Curtis

**Timothy Fitzpatrick
Chairman – Bank**

Stephen Fletcher

Jere Johnston

Craig Kus

Christopher McCoy

Steven Mitchell

**James Park
Chairman – Holding Company**

Debra Winter

April 2007

To Our Shareholders:

The most visible improvement to the Bank of Alpena during 2006 was the completion of our new office building. Open for business in early May, the new facility not only has made it more convenient for our customers, but it confirmed to the community that we are committed to its financial health and well-being.

Though we expected to increase our customer base when the new facility opened, we did not anticipate the level achieved. We experienced the largest impact on market share growth since we opened in 2001. Deposits grew \$17.8 million during the year, a 30% increase from 2005. This represents a 4.4% increase in market share when compared to FDIC statistics for insured deposits in our market.

Though earnings were respectable at \$402,647, they fell short of the level we had projected. Despite a rising interest rate environment during 2006, we were unable to maintain our projected margin over deposit costs, and we saw our net interest margin erode. Bank of Alpena is not alone in this; virtually all banks are struggling with a slowdown in net interest income. Unfortunately, financial experts are indicating that this trend may continue for some time. The soft economy has slowed the demand for loans, forcing banks to price loans more competitively. The result is that banks are not able to match rising deposit costs with corresponding raises in the interest rates charged for loans. Under this scenario, banks will need to grow their balance sheets in order to increase earnings.

During the fall of 2006, Bank of Alpena directors instructed management to develop a three-year strategic plan and gave us the direction to increase Return on Assets (ROA), Return on Equity (ROE), and market share, using our mission statement as a guide. We employed an independent moderator to facilitate the planning session, and the resulting document provides management with broad-reaching and measurable goals. These goals address balance sheet growth, customer service and retention, technology, other income sources, and safety and soundness. As this plan is executed, we are confident that our objectives will be reached.

In February 2007, we added a new financial service to our growing list of products. Julie Ferguson, a licensed financial advisor working out of this office, is now offering investment products through Infinex Investments, Inc. We are excited about this opportunity and invite you to take advantage of this service.

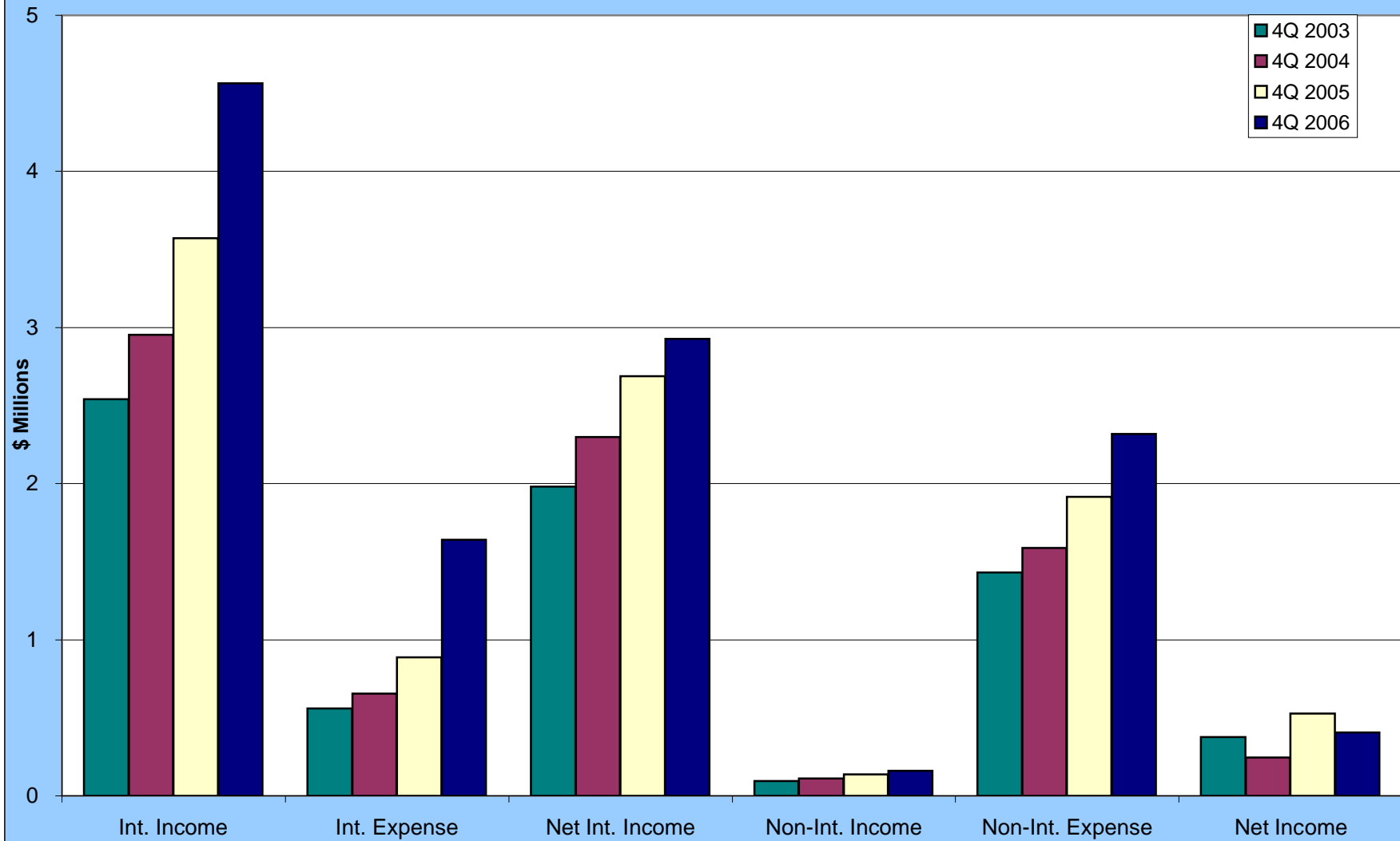
We thank you for your investment, continued commitment and support.

Sincerely,

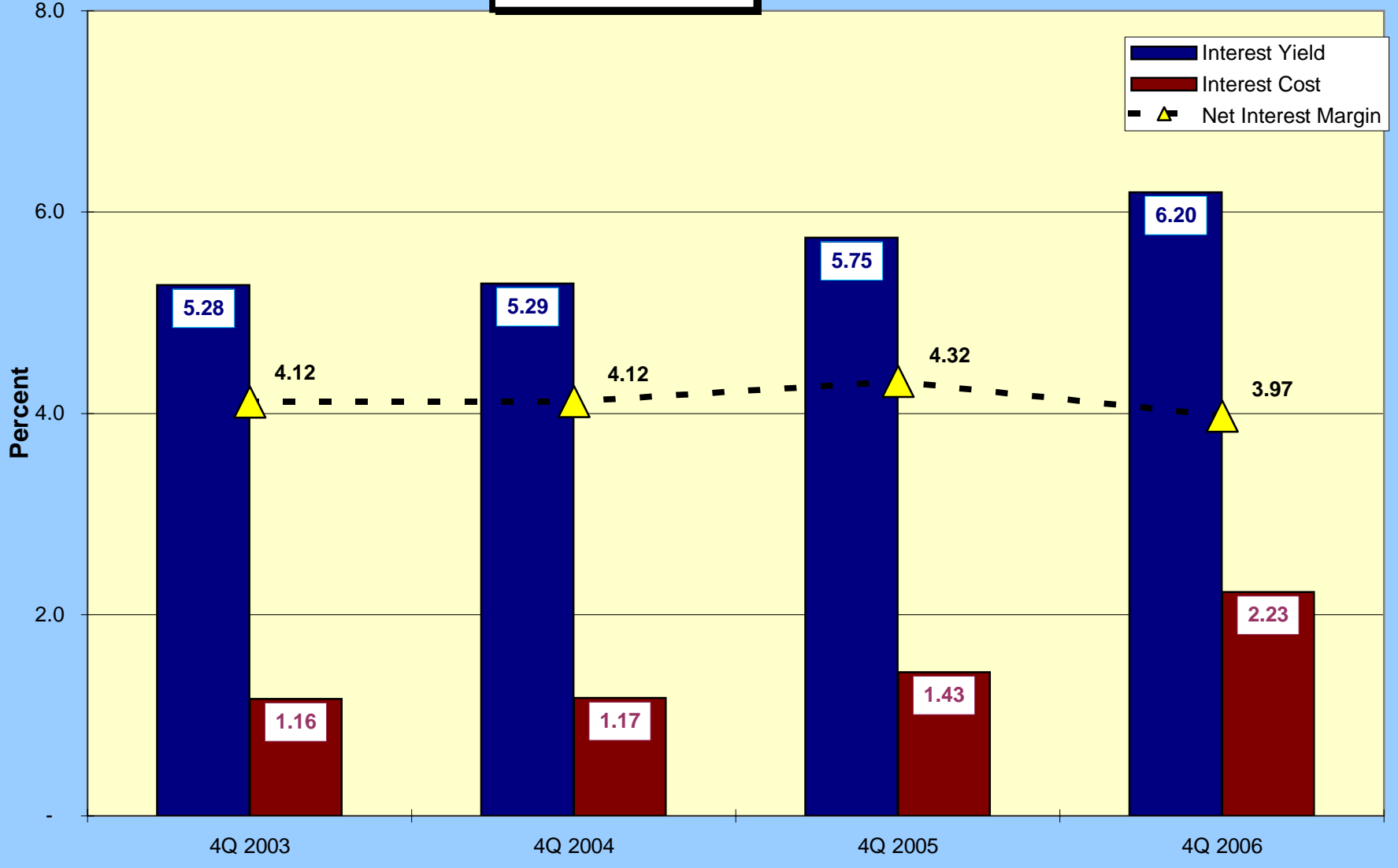
James C. Park
Chairman of the Board
Alpena Banking Corporation

Craig A. Kus
President & CEO
Bank of Alpena

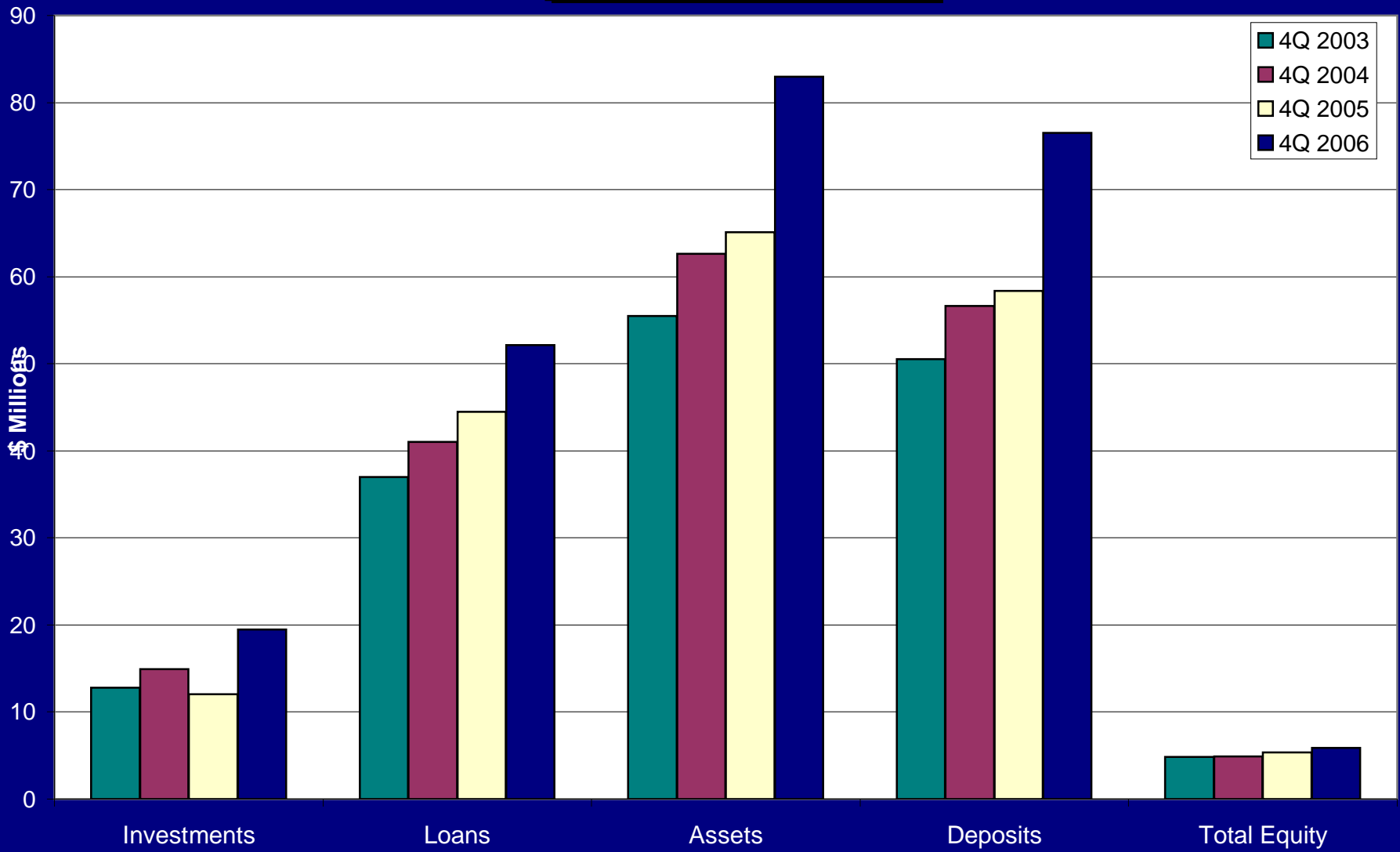
Income Statement Changes



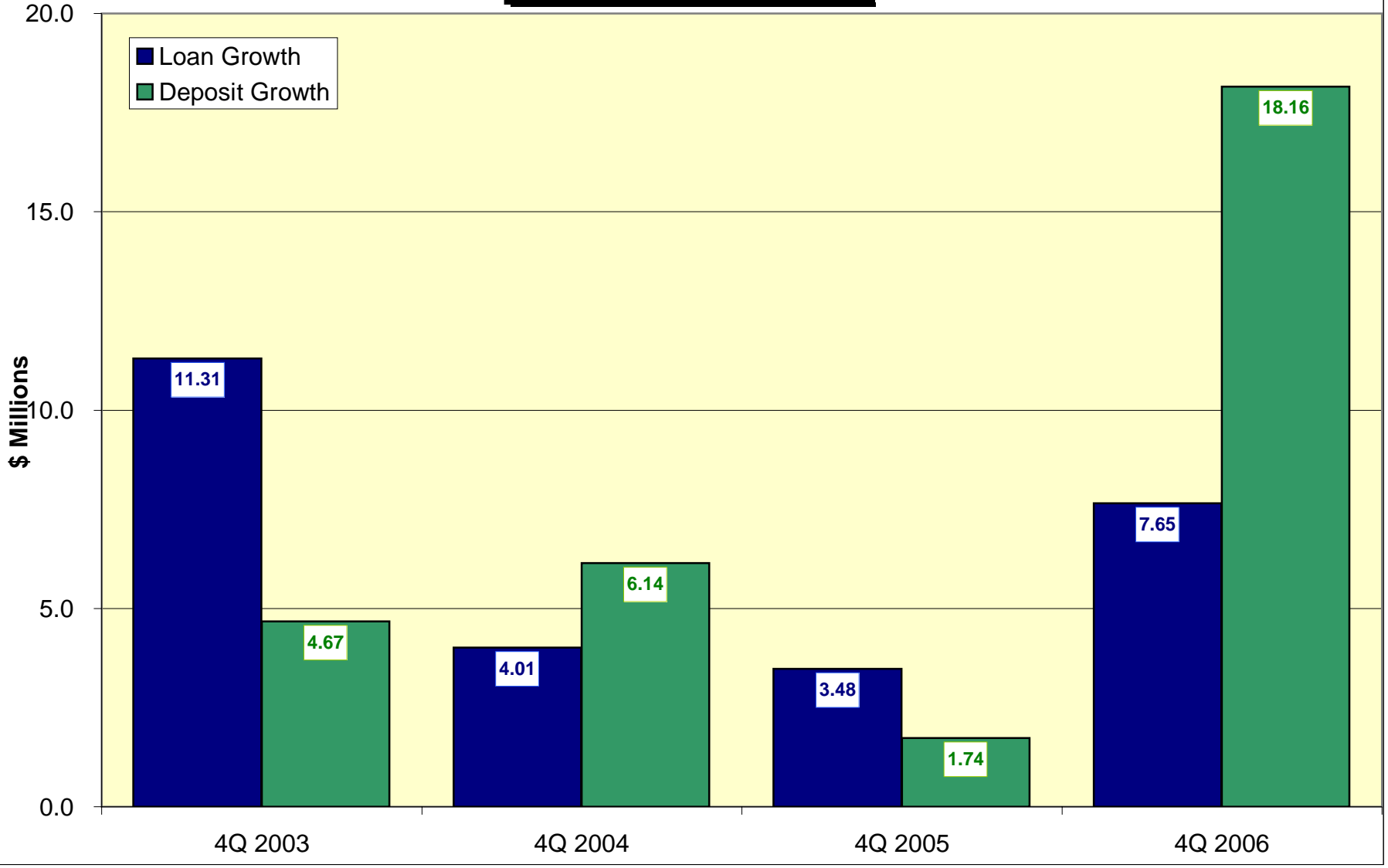
Interest Margin



Balance Sheet Changes



Loan vs Deposit Growth



**ALPENA BANKING CORPORATION
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Board of Directors
Alpena Banking Corporation and Subsidiary
Alpena, Michigan

We have reviewed the accompanying balance sheets of *Alpena Banking Corporation and Subsidiary* (the “Company”) as of December 31, 2006 and 2005, and the related consolidated statements of income, comprehensive income, changes in shareholders’ equity and cash flows for the years then ended, in accordance with *Statements on Standards for Accounting and Review Services* issued by the American Institute of Certified Public Accountants. All information included in these consolidated financial statements is the representation of the management of the Company.

A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the consolidated financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying consolidated financial statements in order for them to conform with generally accepted accounting principles.

Burnside & Lang, P.C.

March 8, 2007
Midland, Michigan

**ALPENA BANKING CORPORATION
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CONSOLIDATED BALANCE SHEETS

ASSETS	December 31	
	2006	2005
Cash and due from banks	\$ 2,886,412	\$ 4,147,942
Federal funds sold	4,522,509	1,873,009
Cash and cash equivalents	7,408,921	6,020,951
Investment securities	19,498,589	12,061,804
Restricted investments	143,300	149,900
Net loans	51,301,391	43,824,681
Accrued interest receivable	409,761	321,520
Premises and equipment, net	3,892,850	2,522,444
Other assets	319,802	238,529
Total assets	<u>\$ 82,974,614</u>	<u>\$ 65,139,829</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Interest bearing	\$ 60,899,684	\$ 47,080,997
Noninterest bearing	15,232,016	11,305,344
Total deposits	76,131,700	58,386,341
Accrued interest payable and other liabilities	589,612	1,031,470
Total liabilities	<u>76,721,312</u>	<u>59,417,811</u>
Commitments and contingencies (Notes 11, 12 and 13)		
Shareholders' equity		
Common stock, no par value; 2,000,000 shares authorized, 533,700 shares issued and outstanding	5,337,000	5,337,000
Retained earnings	931,866	529,219
Accumulated other comprehensive loss	(15,564)	(144,201)
Total shareholders' equity	<u>6,253,302</u>	<u>5,722,018</u>
Total liabilities and shareholders' equity	<u>\$ 82,974,614</u>	<u>\$ 65,139,829</u>

See accompanying notes, which are an integral part of these consolidated financial statements, and accountants' review report.

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CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31	
	2006	2005
Interest income		
Loans, including fees	\$ 3,722,114	\$ 3,111,470
Investment securities	571,377	405,684
Federal funds sold	269,833	53,995
	<hr/>	<hr/>
Total interest income	4,563,324	3,571,149
Interest expense on deposits	1,641,257	886,912
	<hr/>	<hr/>
Net interest income	2,922,067	2,684,237
Provision for loan losses	190,000	124,000
	<hr/>	<hr/>
Net interest income after provision for loan losses	2,732,067	2,560,237
	<hr/>	<hr/>
Noninterest income	170,903	139,942
	<hr/>	<hr/>
Noninterest expenses		
Compensation and benefits	1,358,616	1,121,895
Occupancy and equipment	283,571	189,553
Other	688,630	607,708
	<hr/>	<hr/>
Total noninterest expenses	2,330,817	1,919,156
	<hr/>	<hr/>
Income before federal income taxes	572,153	781,023
	<hr/>	<hr/>
Federal income taxes	169,506	256,400
	<hr/>	<hr/>
Net income	\$ 402,647	\$ 524,623
	<hr/>	<hr/>
Net income per basic share of common stock	\$ 0.75	\$ 0.98
	<hr/>	<hr/>

See accompanying notes, which are an integral part of these consolidated financial statements, and accountants' review report.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31	
	2006	2005
Available-for-sale securities		
Unrealized holding gains (losses) arising during the year	\$ 197,134	\$ (143,116)
Reclassification adjustment for realized gain included in net income	(2,229)	-
Other comprehensive income (loss) before income (taxes) benefit	194,905	(143,116)
Income tax (expense) benefit related to other comprehensive income (loss)	(66,268)	48,659
Other comprehensive income (loss)	128,637	(94,457)
Net income	402,647	524,623
Comprehensive income	<u>\$ 531,284</u>	<u>\$ 430,166</u>

See accompanying notes, which are an integral part of these consolidated financial statements, and accountants' review report.

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CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	<u>Common Stock</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Total Shareholders' Equity</u>
Balances, January 1, 2005	\$ 5,337,000	\$ 4,596	\$ (49,744)	\$ 5,291,852
Comprehensive income	-	524,623	(94,457)	430,166
Balances, December 31, 2005	5,337,000	529,219	(144,201)	5,722,018
Comprehensive income	-	402,647	128,637	531,284
Balances, December 31, 2006	<u>\$ 5,337,000</u>	<u>\$ 931,866</u>	<u>\$ (15,564)</u>	<u>\$ 6,253,302</u>

See accompanying notes, which are an integral part of these consolidated financial statements, and accountants' review report.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31	
	2006	2005
Cash flows from operating activities		
Net income	\$ 402,647	\$ 524,623
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	190,000	124,000
Depreciation	207,203	131,001
Net amortization of securities	22,009	102,956
Net realized gains on calls of available for sale investments	(2,229)	-
Loss on disposal of premises and equipment	7,887	-
Gain on sale of other real estate	-	(861)
Deferred income tax benefit	(36,100)	(24,000)
Changes in operating assets and liabilities which (used) provided cash		
Accrued interest receivable	(88,241)	(37,027)
Other assets	(46,107)	26,032
Accrued interest payable and other liabilities	(441,858)	836,469
Net cash provided by operating activities	<u>215,211</u>	<u>1,683,193</u>
Cash flows from investing activities		
Activity in available-for-sale securities		
Purchases	(14,380,105)	(1,553,192)
Maturities, prepayments and calls	7,118,446	4,141,816
Sales (purchases) of restricted investments	6,600	(3,000)
Proceeds from sale of other real estate	-	82,209
Loan originations and principal collections, net	(7,732,046)	(3,394,828)
Additions to premises and equipment	(1,585,495)	(1,518,552)
Net cash used in investing activities	<u>(16,572,600)</u>	<u>(2,245,547)</u>
Cash flows from financing activities		
Acceptances and withdrawals of deposits, net	17,745,359	2,080,799
Net change in federal funds purchased	-	(871,641)
Net cash provided by financing activities	<u>17,745,359</u>	<u>1,209,158</u>
Net increase in cash and cash equivalents	1,387,970	646,804
Cash and cash equivalents, beginning of year	<u>6,020,951</u>	<u>5,374,147</u>
Cash and cash equivalents, end of year	<u>\$ 7,408,921</u>	<u>\$ 6,020,951</u>
Supplementary cash flows information		
Interest paid	\$ 1,638,486	\$ 875,630
Income taxes paid	\$ 433,750	\$ 51,110

During the year ended December 31, 2006, foreclosed loans in the amount of \$65,336 were transferred to other real estate, which represents a non-cash transaction; such transfers were not significant in 2005.

See accompanying notes, which are an integral part of these consolidated financial statements, and accountants' review report.

**ALPENA BANKING CORPORATION
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business and Concentrations of Risk

The consolidated financial statements include the accounts of *Alpena Banking Corporation*, a registered bank holding company, (the “Company”) and its wholly owned subsidiary, *Bank of Alpena* (the “Bank”). All significant intercompany balances and transactions have been eliminated in consolidation.

The Company is independently owned and operates a community bank engaged in the business of retail and commercial banking services through one branch located in Alpena, Michigan. Active competition, principally from other commercial banks, savings banks and credit unions, exists in all of the Bank’s primary markets. The Bank’s results of operations can be significantly affected by changes in interest rates or changes in the automotive and agricultural industries which comprise a significant portion of the local economic environment.

The Bank’s primary deposit products are interest and noninterest bearing checking accounts, savings accounts and time deposits and their primary lending products are residential and commercial real estate mortgages, commercial and consumer loans. Note 3 further describes the types of lending the Bank engages in and Note 6 provides additional information on deposits. The Bank does not have any significant concentrations to any one industry, customer or depositor, except as described in Note 10. Note 2 discusses the types of securities that the Bank invests in.

The Bank has a state charter and is a member of the Federal Deposit Insurance Corporation (“FDIC”) Bank Insurance Fund. The Bank is subject to the regulations and supervision of the FDIC and the State of Michigan Office of Financial and Insurance Services and undergoes periodic examinations by these regulatory authorities. The Company is further subject to regulations of the Federal Reserve Board (“FRB”) governing bank holding companies.

Use of Estimates

In preparing consolidated financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the year. Actual results could differ from those estimates. The material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Accounting Policies

Accounting policies used in preparation of the accompanying consolidated financial statements conform to predominant banking industry practices and are based on generally accepted accounting principles. The principles which materially affect the determination of the financial position or results of operations of the Company are summarized as follows.

Cash and Cash Equivalents

For the purposes of the statement of cash flows, cash and cash equivalents include cash on hand, balances due from banks and federal funds sold. Generally, federal funds are sold for a one-day period. The Bank maintains deposit accounts in various financial institutions that generally exceed federally insured limits or are not insured.

Securities

Available-for-sale securities consist of bonds, notes and debentures which are recorded at fair value. Unrealized gains and losses, net of the effect of deferred income taxes, on available-for-sale securities are excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In determining whether other-than-temporary impairment exists, management considers many factors, including 1) the length of time and extent to which the fair value has been less than cost, 2) the financial condition and near-term prospects of the issuer and 3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains or losses on the sale of available-for-sale securities are recorded on the trade date and are determined using the specific identification method.

Restricted Investments

The Bank is a member of the Federal Home Loan Bank System and is required to invest in capital stock of the Federal Home Loan Bank (“FHLB”) of Indianapolis. The amount of the required investment, which is carried at cost, is determined and adjusted annually by the FHLB.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding unpaid principal balances adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Management estimates that direct costs incurred in originating loans classified as held-to-maturity approximate the origination fees generated on those loans. Therefore, net deferred loan origination fees on loans classified as held-to-maturity are not included on the accompanying consolidated balance sheets.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well secured and in process of collection. Personal loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal and interest is considered doubtful.

All interest accrued in the current year but not collected for loans placed on non-accrual or charged-off is reversed against interest income while interest accrued but not collected in prior years is reversed against the allowance for loan losses. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. For impaired loans not classified as non-accrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan

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is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank generally does not separately identify individual consumer and residential mortgage loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

Transfers of Financial Assets

Transfers of financial assets, principally participation loans, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is determined to be surrendered when 1) the assets have been isolated from the Bank, 2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and 3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Foreclosed Assets

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value on the date of transfer, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the carrying amount or fair value less costs to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed principally by the straight-line method based upon the useful lives of the related assets, which generally range from 5 to 40 years. Management periodically reviews these assets to determine whether carrying values have been impaired.

Maintenance, repairs and minor alterations are charged to current operations as expenditures occur and major improvements are capitalized.

Off-Balance Sheet Credit Related Financial Instruments

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments to fund lines of credit, commitments to grant loans, and commitments under commercial and standby letters of credit. Such financial instruments are recorded only when they are funded.

Federal Income Taxes

Deferred income tax assets and liabilities are determined using the liability (or balance sheet method). Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Net Income Per Share

Net income per basic share of common stock is calculated on the basis of the weighted average number of shares outstanding, which was 533,700 during each year.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. INVESTMENT SECURITIES

The amortized cost, gross unrealized gains, gross unrealized losses and fair values of available-for-sale securities are as follows as of December 31:

<u>2006</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
Mortgage-backed securities	\$ 4,339,711	\$ 6,338	\$ 34,422	\$ 4,311,627
Government-sponsored enterprises	8,768,736	22,055	35,000	8,755,791
State and municipal	<u>6,413,722</u>	<u>39,915</u>	<u>22,466</u>	<u>6,431,171</u>
Total	<u>\$ 19,522,169</u>	<u>\$ 68,308</u>	<u>\$ 91,888</u>	<u>\$ 19,498,589</u>
 <u>2005</u>				
Mortgage-backed securities	\$ 2,340,571	\$ 523	\$ 59,552	\$ 2,281,542
Government-sponsored enterprises	7,522,227	-	122,225	7,400,002
State and municipal	<u>2,417,491</u>	<u>-</u>	<u>37,231</u>	<u>2,380,260</u>
Total	<u>\$ 12,280,289</u>	<u>\$ 523</u>	<u>\$ 219,008</u>	<u>\$ 12,061,804</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The amortized cost and fair value of available-for-sale securities by contractual maturity are shown below at December 31, 2006.

	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ 4,159,518	\$ 4,118,726
Due after one year through five years	6,915,944	6,944,559
Due after five years through ten years	3,484,434	3,507,795
Due after ten years	<u>622,562</u>	<u>615,882</u>
Subtotal	15,182,458	15,186,962
Mortgage-backed securities - government agencies	<u>4,339,711</u>	<u>4,311,627</u>
Total	<u>\$ 19,522,169</u>	<u>\$ 19,498,589</u>

Because of their variable payments, mortgage backed securities are not reported by a specific maturity group.

The Bank had no sales of available-for-sale securities in 2006 or 2005.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to 1) the length of time and the extent to which the fair value has been less than cost, 2) the financial condition and near-term prospects of the issuer, and 3) the intent and ability of the Bank to retain its investments in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Information pertaining to available-for-sale securities with unrealized losses at December 31, aggregated by investment category and length of time that individual securities have been in a continuous loss position is as follows:

	<u>Less Than</u>		<u>Over Twelve Months</u>		<u>Total</u>
	<u>Unrealized</u>	<u>Fair</u>	<u>Unrealized</u>	<u>Fair</u>	<u>Unrealized</u>
<u>2006</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>
Mortgage-backed securities	\$ 1,990	\$ 979,724	\$ 32,432	\$ 1,641,249	\$ 34,422
Governmental-sponsored enterprises	877	1,501,708	34,123	3,222,734	35,000
State and municipals	<u>7,540</u>	<u>1,317,956</u>	<u>14,926</u>	<u>2,024,613</u>	<u>22,466</u>
Total	<u>\$ 10,407</u>	<u>\$ 3,799,388</u>	<u>\$ 81,481</u>	<u>\$ 6,888,596</u>	<u>\$ 91,888</u>
 <u>2005</u>					
Mortgage-backed securities	\$ 656	\$ 66,491	\$ 58,895	\$ 1,982,574	\$ 59,552
Governmental-sponsored enterprises	2,065	994,844	120,161	6,405,158	122,225
State and municipals	<u>8,390</u>	<u>746,109</u>	<u>28,841</u>	<u>1,634,152</u>	<u>37,231</u>
Total	<u>\$ 11,111</u>	<u>\$ 1,807,444</u>	<u>\$ 207,897</u>	<u>\$10,021,884</u>	<u>\$ 219,008</u>

At December 31, 2006, 29 debt securities have unrealized losses with aggregate depreciation of less than 1% from the Bank's amortized cost basis. These unrealized losses relate to all categories of securities held. As the Bank has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available-for-sale, no declines are deemed to be other than temporary.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. LOANS

The Bank grants commercial, consumer and residential loans to customers situated primarily in a four county area in northeast Michigan. The ability of the borrowers to honor their repayment obligations is often dependent upon the real estate and general economic conditions of this region. Substantially all of the consumer and residential loans are secured by various items of property, while commercial loans are secured primarily by real estate, business assets and personal guarantees; a portion of loans are unsecured.

Major loan classifications are summarized as follows at December 31:

	<u>2006</u>	<u>2005</u>
Mortgage loans on real estate		
Residential 1-4 family	\$ 15,129,650	\$ 12,678,007
Commercial	1,298,198	1,372,517
Construction	1,238,012	546,230
Commercial	32,864,350	28,031,946
Consumer installment loans	1,532,914	1,299,699
Tax exempt	<u>60,210</u>	<u>554,847</u>
 Total loans	 52,123,334	 44,483,246
Less allowance for loan losses	<u>821,943</u>	<u>658,565</u>
 Net loans	 <u>\$ 51,301,391</u>	 <u>\$ 43,824,681</u>

Scheduled maturities of loans with fixed rates of interest are as follows at December 31, 2006:

One year or less	\$ 2,878,986
One to five years	31,608,749
Over five years	<u>5,283,720</u>
 Total	 <u>\$ 39,771,455</u>

Variable rate loans in the amount of \$8,380,377 are repriced quarterly or more frequently. One variable rate loan in the amount of \$3,971,502, (which is 90% guaranteed by a federal agency), reprices every five years.

Loans considered impaired and interest income recognized on such loans was not significant in 2006 or 2005. The Bank has no commitments to loan additional funds to borrowers whose loans are impaired.

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4. ALLOWANCE FOR LOAN LOSSES

The following is a summary of the changes in the allowance for loan losses for the years ended December 31:

	<u>2006</u>	<u>2005</u>
Balance, beginning of year	\$ 658,565	\$ 530,860
Loans charged off	(38,381)	-
Recoveries	<u>11,759</u>	<u>3,705</u>
Net (charge offs) recoveries	(26,622)	3,705
Provision for loan losses	<u>190,000</u>	<u>124,000</u>
Balance, end of year	<u>\$ 821,943</u>	<u>\$ 658,565</u>

5. PREMISES AND EQUIPMENT

A summary of the cost and accumulated depreciation of premises and equipment is as follows at December 31:

	<u>2006</u>	<u>2005</u>
Land	\$ 506,474	\$ 474,274
Buildings and improvements	2,824,304	1,611,557
Furniture and equipment	<u>1,300,848</u>	<u>990,107</u>
Total	4,631,626	3,075,938
Less accumulated depreciation	<u>738,776</u>	<u>553,494</u>
Premises and equipment, net	<u>\$3,892,850</u>	<u>\$2,522,444</u>

Depreciation expense amounted to \$207,203 and \$131,001 for 2006 and 2005, respectively.

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6. DEPOSITS

A summary of the distribution of deposits is as follows at December 31:

	<u>2006</u>	<u>2005</u>
Interest bearing		
Money market and NOW accounts	\$ 38,591,436	\$ 22,066,518
Savings	2,569,538	3,766,888
Individual retirement saving accounts	301,455	220,868
Certificates of deposit	<u>19,437,255</u>	<u>21,026,723</u>
Total interest bearing	60,899,684	47,080,997
Non-interest bearing demand	<u>15,232,016</u>	<u>11,305,344</u>
Total deposits	<u>\$ 76,131,700</u>	<u>\$ 58,386,341</u>

Time deposits issued in denominations of \$100,000 or more amounted to \$9,772,227 and \$15,173,902 at December 31, 2006 and 2005, respectively. Interest expense on time deposits issued in denominations of \$100,000 or more was \$489,285 in 2006 and \$506,561 in 2005.

Scheduled maturities of time deposits are as follows at December 31, 2006:

2007	\$ 15,175,318
2008	3,720,426
2009	313,536
2010	10,647
2011	<u>217,328</u>
	<u>\$ 19,437,255</u>

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7. ACCOUNTS PAYABLE AND OTHER LIABILITIES

A summary of accounts payable and other liabilities is as follows at December 31:

	<u>2006</u>	<u>2005</u>
Accounts payable-construction in progress	\$ -	\$ 229,776
Federal and state income taxes payable	61,783	294,735
Land contract payable	246,705	262,566
Accrued interest payable and other liabilities	<u>281,124</u>	<u>244,393</u>
Total accounts payable and other liabilities	<u>\$ 589,612</u>	<u>\$1,031,470</u>

8. FEDERAL INCOME TAXES

The provision for federal income taxes consists of the following components for the years ended December 31:

	<u>2006</u>	<u>2005</u>
Current	\$ 205,606	\$ 280,400
Deferred benefit	<u>(36,100)</u>	<u>(24,000)</u>
Federal income taxes	<u>\$ 169,506</u>	<u>\$ 256,400</u>

A reconciliation between federal income tax expense reported and the amount computed by applying the statutory federal income tax rate of 34% to income before federal income taxes is as follows for the years ended December 31:

	<u>2006</u>	<u>2005</u>
Income taxes at statutory rate	\$ 194,500	\$ 266,000
Effect of tax exempt interest income	(32,000)	(9,600)
Other	<u>7,006</u>	<u>-</u>
Federal income taxes	<u>\$ 169,506</u>	<u>\$ 256,400</u>

The components of the net deferred asset, which is included in other assets on the accompanying balance sheets, are primarily related to temporary basis differences in the allowance for loan losses, unrealized loss on available-for-sale securities and premises and equipment.

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9. EMPLOYEE BENEFIT PLAN

The Bank maintains a retirement savings plan qualified under Section 401(k) of the Internal Revenue Code. Under this plan, eligible employees are permitted to contribute an amount of eligible compensation into the retirement plan up to a maximum determined by the Internal Revenue Code. At the discretion of the Board of Directors, the Bank may make a matching contribution of up to 3% of a participant's salary. Contributions to this plan charged to expense were \$30,367 and \$23,915 for 2006 and 2005, respectively.

10. RELATED PARTY TRANSACTIONS

Loans

In the ordinary course of business, the Bank has granted loans to certain directors, executive officers and their affiliates. Annual activity consisted of the following during the year ended December 31:

	<u>2006</u>	<u>2005</u>
Beginning balance	\$ 1,691,906	\$ 2,688,638
New loans	1,668,337	318,172
Repayments	<u>(837,575)</u>	<u>(1,314,904)</u>
Ending balance	<u>\$ 2,522,668</u>	<u>\$ 1,691,906</u>

Deposits

Deposits of Bank directors, executive officers and their related interests were approximately \$36,247,000 and \$32,404,000 at December 31, 2006 and 2005, respectively, which represent 48% and 56% of total deposits, respectively.

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11. OFF-BALANCE-SHEET ACTIVITIES

Credit-Related Financial Instruments

The Bank is a 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, standby letters of credit and commercial 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 Bank's exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policy in making commitments, including collateral, as it does for on-balance-sheet instruments; no significant losses are anticipated as a result of these commitments.

The following financial instruments were outstanding whose contract amounts represent credit risk at December 31:

	<u>2006</u>	<u>2005</u>
Commitments to grant loans	\$ 238,538	\$1,591,580
Unfunded commitments under lines of credit	3,359,894	1,858,150
Commercial and standby letters of credit	32,000	482,000

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. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed; a portion is unsecured.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These 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 Bank generally holds collateral supporting those commitments if deemed necessary.

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12. REGULATORY REQUIREMENTS

Capital Requirements

The Bank is subject to various regulatory capital requirements administered by federal banking agencies. For bank holding companies with less than \$150 million in consolidated assets, the regulatory capital requirements are applied on a bank-only basis. Failure to meet minimum regulatory capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines involving quantitative measures of its assets, liabilities, capital and certain off-balance-sheet items as defined in the regulations and calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital to risk weighted assets and Tier 1 capital to average assets. Management believes, as of December 31, 2006 and 2005, that the Bank met all the capital adequacy requirements to which the institution is subject.

As of December 31, 2006, the most recent notification from the FDIC categorized the Bank as 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 1 risk-based, and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amount and ratios as of December 31, 2006 and 2005 are also presented in the table.

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	<u>Actual Capital</u>		<u>Minimum Capital Requirement</u>		<u>Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<u>(Dollars in thousands)</u>						
<u>December 31, 2006</u>						
Total capital to risk weighted assets	\$ 6,556	12.64%	\$ 4,150	8.00%	\$ 5,188	10.00%
Tier 1 capital to risk weighted assets	5,907	11.39	2,075	4.00	3,133	6.00
Tier 1 capital to average assets	5,907	8.04	2,938	4.00	3,673	6.00
<u>December 31, 2005</u>						
Total capital to risk weighted assets	\$ 6,034	14.15%	\$ 3,411	8.00%	\$ 4,264	10.00%
Tier 1 capital to risk weighted assets	5,501	12.90	1,705	4.00	2,588	6.00
Tier 1 capital to average assets	5,501	8.84	2,488	4.00	3,110	5.00
<u>Reserve Balances</u>						

The Bank is currently required by regulatory agencies to maintain legal cash reserves in the amount of \$35,000 based on the level of certain customer deposits.

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Restrictions on Dividends, Loans and Advances

Federal and state banking regulations place certain restrictions on the amounts of loans or advances that can be extended to the Company by the Bank and dividends that can be paid to the Company by the Bank. The total amount of dividends which may be paid at any date is generally limited to the retained earnings of the Bank and loans or advances are limited to 10 percent of the Bank's capital stock and surplus on a secured basis. In addition, dividends paid by the Bank to the Company would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements.

13. COMMITMENTS AND CONTINGENCIES

Litigation

The Company is party to litigation arising during the normal course of business. In the opinion of management, based on consultation with legal counsel, the resolution of such litigation is not expected to have a material effect on the consolidated financial statements.

Environmental Issues

As a result of acquiring real estate from foreclosure proceedings, the Bank is subject to potential claims and possible legal proceedings involving environmental matters. No such claims have been asserted as of December 31, 2006 or 2005.

14. CREDIT FACILITIES

The Bank has \$1,310,000 in borrowing availability under an Advances, Pledge, and Security Agreement with the Federal Home Loan Bank ("FHLB") of Indianapolis; no advances were outstanding under this arrangement at December 31, 2006 or 2005.

The Bank also has a credit facility available from Bank One in the amount of \$4,000,000. Borrowings outstanding under this arrangement would be reported as federal funds purchased in the accompanying consolidated balance sheets and have a one-day maturity. There were no such borrowings outstanding under this agreement at December 31, 2006 or 2005. Interest terms are determined at the time of each advance.

The Bank has pledged investment securities in the amount of \$6,311,000 par value (\$5,750,000 in 2005) as collateral for outstanding borrowings for both lines of credit.
