

AMES NATIONAL CORP  
Form 10-Q  
November 08, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

FORM 10-Q

[Mark One]

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2007

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-32637

**AMES NATIONAL CORPORATION**  
(Exact Name of Registrant as Specified in Its Charter)

**IOWA**  
(State or Other Jurisdiction of Incorporation or Organization)

**42-1039071**  
(I. R. S. Employer Identification Number)

**405 FIFTH STREET  
AMES, IOWA 50010**  
(Address of Principal Executive Offices)

Registrant's Telephone Number, Including Area Code: **(515) 232-6251**

**NOT APPLICABLE**  
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the registrant 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.

**COMMON STOCK, \$2.00 PAR VALUE**  
(Class)

**9,429,580**  
(Shares Outstanding at November 1, 2007)

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## AMES NATIONAL CORPORATION

## INDEX

Page

|                 |  |    |
|-----------------|--|----|
| <b>PART I.</b>  | <b><u>FINANCIAL INFORMATION</u></b>  |    |
| Item 1.         | <u>Consolidated Financial Statements (Unaudited)</u>   |    |
|                 | <u>Consolidated Balance Sheets at September 30, 2007 and December 31, 2006</u>                           | 3  |
|                 | <u>Consolidated Statements of Income for the three and nine months ended September 30, 2007 and 2006</u> | 4  |
|                 | <u>Consolidated Statements of Cash Flows for the nine months ended September 30, 2007 and 2006</u>       | 5  |
|                 | <u>Notes to Consolidated Financial Statements</u>  | 6  |
| Item 2.         | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>             | 7  |
| Item 3.         | <u>Quantitative and Qualitative Disclosures About Market Risk</u>  | 22 |
| Item 4.         | <u>Controls and Procedures</u>   | 22 |
| <b>PART II.</b> | <b><u>OTHER INFORMATION</u></b>  |    |
|                 | <u>Items 1 through 6</u>   | 23 |
|                 | <u>Signatures</u>  | 24 |

Index

## AMES NATIONAL CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets  
(unaudited)

| ASSETS   | September 30,<br>2007 | December 31,<br>2006  |
|--|-----------------------|-----------------------|
| Cash and due from banks  | \$ 25,654,272         | \$ 16,510,082         |
| Federal funds sold   | -                     | 13,100,000            |
| Interest bearing deposits in financial institutions  | 661,885               | 1,544,306             |
| Securities available-for-sale  | 341,089,875           | 354,571,864           |
| Loans receivable, net  | 457,864,361           | 429,122,541           |
| Loans held for sale  | 754,433               | 525,999               |
| Bank premises and equipment, net   | 13,719,670            | 12,617,741            |
| Accrued income receivable  | 8,408,901             | 7,871,365             |
| Other assets   | 3,139,478             | 2,989,090             |
| <b>Total assets</b>  | <b>\$ 851,292,875</b> | <b>\$ 838,852,988</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                       |                       |
| <b>LIABILITIES</b>   |                       |                       |
| Deposits   |                       |                       |
| Demand, noninterest bearing  | \$ 71,653,364         | \$ 77,638,264         |
| NOW accounts   | 145,788,086           | 158,584,115           |
| Savings and money market   | 144,800,475           | 159,401,753           |
| Time, \$100,000 and over   | 108,556,497           | 102,230,631           |
| Other time   | 180,181,480           | 182,501,710           |
| <b>Total deposits</b>  | <b>650,979,902</b>    | <b>680,356,473</b>    |
| Federal funds purchased and securities sold under agreements to repurchase   | 55,232,215            | 34,727,897            |
| Other short-term borrowings  | 3,361,535             | 1,470,116             |
| Long-term term borrowings  | 23,000,000            | 2,000,000             |
| Dividends payable  | 2,545,987             | 2,450,503             |
| Deferred income taxes  | -                     | 1,187,948             |
| Accrued expenses and other liabilities   | 4,555,396             | 3,736,739             |
| <b>Total liabilities</b>   | <b>739,675,035</b>    | <b>725,929,676</b>    |
| <b>STOCKHOLDERS' EQUITY</b>  |                       |                       |
| Common stock, \$2 par value, authorized 18,000,000 shares; 9,429,580 and 9,425,013 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively | 18,859,160            | 18,850,026            |
| Additional paid-in capital   | 22,588,691            | 22,498,904            |
| Retained earnings  | 66,506,883            | 65,856,627            |
| Accumulated other comprehensive income, net unrealized gain on securities available-for-sale   | 3,663,106             | 5,717,755             |
| <b>Total stockholders' equity</b>  | <b>111,617,840</b>    | <b>112,923,312</b>    |

|   |                |                |
|---|----------------|----------------|
| <b>Total liabilities and stockholders' equity</b> | \$ 851,292,875 | \$ 838,852,988 |
|---|----------------|----------------|

3

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Index**AMES NATIONAL CORPORATION AND SUBSIDIARIES**Consolidated Statements of Income  
(unaudited)

|   | <b>Three Months Ended</b> |                   | <b>Nine Months Ended</b> |                   |
|---|---------------------------|-------------------|--------------------------|-------------------|
|   | <b>September 30,</b>      |                   | <b>September 30,</b>     |                   |
|   | <b>2007</b>               | <b>2006</b>       | <b>2007</b>              | <b>2006</b>       |
| Interest and dividend income:                                       |                           |                   |                          |                   |
| Loans   | \$ 8,062,624              | \$ 7,504,606      | \$ 23,500,424            | \$ 22,064,447     |
| Securities  |                           |                   |                          |                   |
| Taxable   | 2,322,438                 | 2,320,638         | 6,981,845                | 6,488,712         |
| Tax-exempt  | 1,218,921                 | 1,045,124         | 3,603,235                | 3,121,681         |
| Federal funds sold  | 2,132                     | 40,918            | 181,523                  | 144,911           |
| Dividends   | 397,137                   | 353,659           | 1,171,687                | 1,052,437         |
| <b>Total interest income</b>  | <b>12,003,252</b>         | <b>11,264,945</b> | <b>35,438,714</b>        | <b>32,872,188</b> |
| Interest expense:   |                           |                   |                          |                   |
| Deposits  | 5,232,913                 | 5,111,121         | 16,041,795               | 14,515,383        |
| Other borrowed funds  | 789,136                   | 497,354           | 1,804,055                | 1,097,577         |
| <b>Total interest expense</b>                                       | <b>6,022,049</b>          | <b>5,608,475</b>  | <b>17,845,850</b>        | <b>15,612,960</b> |
| <b>Net interest income</b>  | <b>5,981,203</b>          | <b>5,656,470</b>  | <b>17,592,864</b>        | <b>17,259,228</b> |
| Provision (credit) for loan losses                                  | (264,131)                 | 45,859            | (110,527)                | (227,371)         |
| <b>Net interest income after provision (credit) for loan losses</b> | <b>6,245,334</b>          | <b>5,610,611</b>  | <b>17,703,391</b>        | <b>17,486,599</b> |
| Non-interest income:  |                           |                   |                          |                   |
| Trust department income   | 438,383                   | 336,207           | 1,543,048                | 1,089,285         |
| Service fees  | 479,930                   | 474,633           | 1,383,137                | 1,379,684         |
| Securities gains, net   | 537,969                   | 330,827           | 1,444,047                | 846,135           |
| Gain on sale of loans held for sale                                 | 241,548                   | 173,163           | 539,652                  | 457,150           |
| Merchant and ATM fees   | 143,859                   | 127,108           | 426,144                  | 403,328           |
| Gain on foreclosure of real estate                                  | —                         | 10,734            | —                        | 482,203           |
| Other   | 146,284                   | 118,701           | 430,943                  | 404,894           |
| <b>Total non-interest income</b>                                    | <b>1,987,973</b>          | <b>1,571,373</b>  | <b>5,766,971</b>         | <b>5,062,679</b>  |
| Non-interest expense:   |                           |                   |                          |                   |
| Salaries and employee benefits                                      | 2,480,547                 | 2,341,368         | 7,543,814                | 7,128,646         |
| Data processing   | 535,527                   | 541,865           | 1,643,884                | 1,624,142         |
| Occupancy expenses  | 344,227                   | 294,113           | 965,715                  | 891,991           |
| Provision for off-balance sheet commitments                         | 233,000                   | —                 | 233,000                  | —                 |
| Other operating expenses  | 711,887                   | 639,067           | 2,146,260                | 2,024,029         |

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|                                      |              |              |              |              |
|--------------------------------------|--------------|--------------|--------------|--------------|
| Total non-interest expense           | 4,305,188    | 3,816,413    | 12,532,673   | 11,668,808   |
| Income before income taxes           | 3,928,119    | 3,365,571    | 10,937,689   | 10,880,470   |
| Income tax expense                   | 989,580      | 819,999      | 2,650,706    | 2,657,713    |
| Net income                           | \$ 2,938,539 | \$ 2,545,572 | \$ 8,286,983 | \$ 8,222,757 |
| Basic and diluted earnings per share | \$ 0.31      | \$ 0.27      | \$ 0.88      | \$ 0.87      |
| Declared dividends per share         | \$ 0.27      | \$ 0.26      | \$ 0.81      | \$ 0.78      |
| Comprehensive Income                 | \$ 4,091,849 | \$ 6,971,733 | \$ 6,232,334 | \$ 9,771,335 |

4

Index

## AMES NATIONAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cashflows  
(unaudited)

|  | Nine Months Ended<br>September 30, |                    |
|--|------------------------------------|--------------------|
|  | 2007                               | 2006               |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                                    |                    |
| Net income   | \$ 8,286,983                       | \$ 8,222,757       |
| Adjustments to reconcile net income to net cash provided by operating activities:      |                                    |                    |
| Credit for loan losses   | (110,527)                          | (227,371)          |
| Provision for off-balance sheet commitments  | 233,000                            | —                  |
| Amortization and accretion   | (162,610)                          | 133,426            |
| Depreciation   | 788,951                            | 720,603            |
| Provision for deferred taxes   | 5,264                              | 151,694            |
| Securities gains, net  | (1,444,047)                        | (846,135)          |
| Gain on foreclosure of real estate   | —                                  | (482,203)          |
| Change in assets and liabilities:  |                                    |                    |
| Increase (decrease) in loans held for sale   | (228,434)                          | 390,095            |
| Decrease in accrued income receivable  | (537,536)                          | (1,694,553)        |
| Increase in other assets   | (136,900)                          | (222,375)          |
| Increase in accrued expenses and other liabilities                                     | 585,657                            | 2,016,384          |
| <b>Net cash provided by operating activities</b>                                       | <b>7,279,801</b>                   | <b>8,162,322</b>   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                                    |                    |
| Purchase of securities available-for-sale  | (46,780,067)                       | (51,901,443)       |
| Proceeds from sale of securities available-for-sale                                    | 6,076,548                          | 4,925,519          |
| Proceeds from maturities and calls of securities available-for-sale                    | 52,530,817                         | 31,727,977         |
| Net decrease in interest bearing deposits in financial institutions                    | 882,421                            | 2,652,453          |
| Net decrease in federal funds sold   | 13,100,000                         | 250,000            |
| Net decrease (increase) in loans   | (28,631,293)                       | 15,696,626         |
| Purchase of bank premises and equipment  | (1,890,880)                        | (1,603,606)        |
| <b>Net cash (used in) provided by investing by activities</b>                          | <b>(4,712,454)</b>                 | <b>1,747,526</b>   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                                    |                    |
| Decrease in deposits   | (29,376,571)                       | (18,681,500)       |
| Increase in federal funds purchased and securities sold under agreements to repurchase | 20,504,318                         | 14,409,801         |
| Increase in other borrowings, net  | 22,891,419                         | 1,411,764          |
| Dividends paid   | (7,541,244)                        | (7,254,332)        |
| Proceeds from issuance of common stock   | 98,921                             | 127,013            |
| <b>Net cash provided by (used in) financing activities</b>                             | <b>6,576,843</b>                   | <b>(9,987,254)</b> |
| <b>Net increase (decrease) in cash and cash equivalents</b>                            | <b>9,144,190</b>                   | <b>(77,406)</b>    |
| <b>CASH AND DUE FROM BANKS</b>   |                                    |                    |



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|                    |               |               |
|--------------------|---------------|---------------|
| Beginning          | 16,510,082    | 18,092,139    |
| Ending             | \$ 25,654,272 | \$ 18,014,733 |
| Cash payments for: |               |               |
| Interest           | \$ 17,688,771 | \$ 15,515,486 |
| Income taxes       | 2,526,719     | 2,869,358     |

5

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**Index**

**AMES NATIONAL CORPORATION AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

1. Significant Accounting Policies

The consolidated financial statements for the three and nine month periods ended September 30, 2007 and 2006 are unaudited. In the opinion of the management of Ames National Corporation (the "Company"), these financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary to present fairly these consolidated financial statements. The results of operations for the interim periods are not necessarily indicative of results which may be expected for an entire year. Certain information and footnote disclosures normally included in complete financial statements prepared in accordance with generally accepted accounting principles have been omitted in accordance with the requirements for interim financial statements. The interim financial statements and notes thereto should be read in conjunction with the year-end audited financial statements contained in the Company's 10-K. The consolidated condensed financial statements include the accounts of the Company and its wholly-owned banking subsidiaries (the "Banks"). All significant intercompany balances and transactions have been eliminated in consolidation.

2. Dividends

On August 8, 2007, the Company declared a cash dividend on its common stock, payable on November 15, 2007 to stockholders of record as of November 1, 2007, equal to \$0.27 per share.

3. Earnings Per Share

Earnings per share amounts were calculated using the weighted average shares outstanding during the periods presented. The weighted average outstanding shares for the three months ended September 30, 2007 and 2006 were 9,429,580 and 9,425,013 respectively. The weighted average outstanding shares for the nine months ended September 30, 2007 and 2006 were 9,426,803 and 9,421,522, respectively.

4. Off-Balance Sheet Arrangements

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. No material changes in the Company's off-balance sheet arrangements have occurred since December 31, 2006.

5. Long-term Debt

The Company borrowed funds through selling securities under an agreement to repurchase to a money center bank totaling \$20,000,000 in the third quarter of 2007. The term of the repurchase agreements ranged from two to five years with interest rates ranging from 4.09% to 4.40%.

6. New Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 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 its tax return. The Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim

periods, disclosure and transition. FIN 48 is effective in fiscal years beginning after December 15, 2006. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption, with the cumulative effect adjustment reported as an adjustment to the opening balance of retained earnings. The Company adopted FIN 48 as of January 1, 2007, and the adoption had no significant impact on the consolidated financial statements.

**Index**

The following are disclosures made pursuant to the initial adoption of FIN 48:

- Accounting policy regarding classification of interest and penalties:

The Company has adopted the policy of classifying interest and penalties as income tax expense.

- Unrecognized tax benefits as of date of adoption:

The Company had no significant unrecognized tax benefits as of January 1, 2007 and, likewise, no significant unrecognized tax benefits that, if recognized, would affect the effective tax rate.

- Total interest and penalties recognized:

The Company had recorded no accrued interest or penalties as of the date of adoption.

- Uncertainty on tax position:

The Company had no positions for which it deemed that it is reasonably possible that the total amounts of the unrecognized tax benefit will significantly increase or decrease within the 12 months of the date of adoption.

- Open tax years:

The tax years that remain subject to examination by major tax jurisdictions currently are:

Federal 2004 - 2006

State of Iowa 2004 - 2006

On February 15, 2007, FASB issued Statement of Financial Accounting Standards No. 159, the Fair Value Option for Financial Assets and Financial Liabilities, a standard that provides companies with an option to report selected financial assets and liabilities at fair value. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. The new statement does not eliminate disclosure requirements included in other accounting standards.

This statement is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided, among other things, that the entity makes that choice in the first 120 days of that fiscal year.

The Company will adopt the standard effective January 1, 2008. The Company has not determined the impact that the standard might have on its consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

**Overview**

Ames National Corporation is a bank holding company established in 1975 that owns and operates five bank subsidiaries in central Iowa. The following discussion is provided for the consolidated operations of the Company and its Banks, First National Bank, Ames, Iowa (First National), State Bank & Trust Co. (State Bank), Boone Bank & Trust Co. (Boone Bank), Randall-Story State Bank (Randall-Story Bank) and United Bank & Trust NA (United Bank). The purpose of this discussion is to focus on significant factors affecting the Company's financial condition and results of operations.



**Index**

The Company does not engage in any material business activities apart from its ownership of the Banks. Products and services offered by the Banks are for commercial and consumer purposes including loans, deposits and trust services. The Banks also offer investment services through a third-party broker dealer. The Company employs twelve individuals to assist with financial reporting, human resources, audit, compliance, marketing, technology systems and the coordination of management activities, in addition to 185 full-time equivalent individuals employed by the Banks.

The Company's primary competitive strategy is to utilize seasoned and competent Bank management and local decision making authority to provide customers with faster response times and more flexibility in the products and services offered. This strategy is viewed as providing an opportunity to increase revenues through creating a competitive advantage over other financial institutions. The Company also strives to remain operationally efficient to provide better profitability while enabling the Company to offer more competitive loan and deposit rates.

The principal sources of Company revenues and cashflow are: (i) interest and fees earned on loans made by the Banks; (ii) securities gains and dividends on equity investments held by the Company and the Banks; (iii) service charges on deposit accounts maintained at the Banks; (iv) interest on fixed income investments held by the Banks; and (v) fees on trust services provided by those Banks exercising trust powers. The Company's principal expenses are: (i) interest expense on deposit accounts and other borrowings; (ii) salaries and employee benefits; (iii) data processing costs associated with maintaining the Bank's loan and deposit functions; and (iv) occupancy expenses for maintaining the Banks' facilities. The largest component contributing to the Company's net income is net interest income, which is the difference between interest earned on earning assets (primarily loans and investments) and interest paid on interest bearing liabilities (primarily deposits and other borrowings). One of management's principal functions is to manage the spread between interest earned on earning assets and interest paid on interest bearing liabilities in an effort to maximize net interest income while maintaining an appropriate level of interest rate risk.

Net income for the third quarter of 2007 was \$2,939,000, or \$0.31 per share, a 15% increase above the \$2,546,000 or \$0.27 per share earned during the same period in 2006. The improvement in earnings can be attributed to higher net interest income which increased \$325,000, as well as increases in trust revenues of \$102,000 and securities gains of \$207,000. Partially offsetting some of the income gains was higher non-interest expense primarily related to First National Bank's new office in Ankeny, Iowa.

For the nine month period ending September 30, 2007, the Company earned net income of \$8,287,000, or \$0.88 per share, a 1% increase from net income of \$8,223,000, or \$0.87 per share, earned a year ago. Current year earnings were aided by an improving net interest margin which was 3.32% compared to 3.29% for the nine month period ending September 30, 2007 and 2006, respectively. This margin improvement increased net interest income for the current nine month period by \$334,000 compared to the same period 2006. Favorable conditions in the equity markets allowed the Company to realize net security gains that were \$597,000 over the previous year. Trust department income was also up over 2006 by \$454,000.

The following management discussion and analysis will provide a summary review of important items relating to:

- - 
  - 
  -
- Challenges
  - Key Performance Indicators and Industry Results
  - Income Statement Review
  - Balance Sheet Review

**Index**

- Asset Quality and Credit Risk Management
- Liquidity and Capital Resources
- Forward-Looking Statements and Business Risks

**Challenges**

Management has identified certain challenges that may negatively impact the Company's revenues in the future and is attempting to position the Company to best respond to those challenges.

- Short-term interest rates have increased significantly since September of 2004 while longer term rates (10 to 20 years) are relatively unchanged since 2004. This movement in short-term rates has caused the yield curve to be flatter or slightly inverted since June 30, 2006. Banks have historically earned higher levels of net interest income by investing in intermediate and longer term loans and investments at higher yields and paying lower deposit expense rates on shorter maturity deposits. If the yield curve remains flat or inverted for the remainder of 2007, the Company's net interest margin may compress.
- If interest rates rise, maintaining net interest income revenues presents a challenge to the Company in 2007. Increases in interest rates may negatively impact the Company's net interest margin as interest expense increases more quickly than interest income. The Company's earning assets (primarily its loan and investment portfolio) have longer maturities than its interest bearing liabilities (primarily deposits and other borrowings); therefore, in a rising interest rate environment, interest expense will increase more quickly than interest income as the interest bearing liabilities reprice more quickly than earning assets. In response to this challenge, the Banks model quarterly the changes in income that would result from various changes in interest rates. Management believes Bank earning assets have the appropriate maturity and repricing characteristics to optimize earnings and the Banks' interest rate risk positions.
- The Company's market in central Iowa has numerous banks, credit unions, and investment and insurance companies competing for similar business opportunities. This competitive environment will continue to put downward pressure on the Banks' net interest margins and thus affect profitability. Strategic planning efforts at the Company and Banks continue to focus on capitalizing on the Banks' strengths in local markets while working to identify opportunities for improvement to gain competitive advantages.
- A potential challenge to the Company's earnings would be poor performance in the Company's equity portfolio, thereby reducing the historical level of realized security gains. The Company, on an unconsolidated basis, invests capital that may be utilized for future expansion in a portfolio of primarily financial and utility stocks totaling \$22 million as of September 30, 2007. The Company focuses on stocks that have historically paid dividends that may lessen the negative effects of a bear market.
- The sub-prime mortgage market has had a negative impact on the financial services industry during 2007. The Company has minimal direct exposure to subprime or option adjustable rate mortgages in its loan and bond portfolios. The financial stocks held in the Company's equity portfolio present an indirect exposure to the current problems in the mortgage market.

Index**Key Performance Indicators and Industry Results**

Certain key performance indicators for the Company and the industry are presented in the following chart. The industry figures are compiled by the Federal Deposit Insurance Corporation (FDIC) and are derived from 8,615 commercial banks and savings institutions insured by the FDIC. Management reviews these indicators on a quarterly basis for purposes of comparing the Company's performance from quarter to quarter against the industry as a whole.

## Selected Indicators for the Company and the Industry

|                     | September 30, 2007 |                | June 30, 2007  |           | Years Ended December 31, |          |         |          |
|---------------------|--------------------|----------------|----------------|-----------|--------------------------|----------|---------|----------|
|                     | 3 Months Ended     | 9 Months Ended | 3 Months Ended |           | 2006                     |          | 2005    |          |
|                     | Company            | Company        | Company        | Industry* | Company                  | Industry | Company | Industry |
| Return on assets    | 1.39%              | 1.31%          | 1.33%          | 1.21%     | 1.34%                    | 1.28%    | 1.40%   | 1.28%    |
| Return on equity    | 10.69%             | 9.92%          | 10.09%         | 11.54%    | 9.99%                    | 12.34%   | 10.57%  | 12.46%   |
| Net interest margin | 3.39%              | 3.32%          | 3.31%          | 3.34%     | 3.29%                    | 3.31%    | 3.56%   | 3.49%    |
| Efficiency ratio    | 54.02%             | 53.65%         | 51.68%         | 56.52%    | 52.27%                   | 56.79%   | 49.09%  | 57.24%   |
| Capital ratio       | 13.05%             | 13.19%         | 13.19%         | 8.18%     | 13.38%                   | 8.23%    | 13.21%  | 8.25%    |

\*Latest available data

Key performances indicators include:

- Return on Assets

This ratio is calculated by dividing net income by average assets. It is used to measure how effectively the assets of the Company are being utilized in generating income. The Company's annualized return on average assets was 1.39% and 1.25%, respectively, for the three month periods ending September 30, 2007 and 2006. The ratio improved in 2007 from the previous year primarily as the result of improving net interest income, trust revenues, and security gains.

- Return on Equity

This ratio is calculated by dividing net income by average equity. It is used to measure the net income or return the Company generated for the shareholders' equity investment in the Company. The Company's annualized return on equity ratio is below that of the industry primarily as a result of the higher level of capital the Company maintains for future growth and acquisitions. The Company's return on average equity was 10.69% and 9.36%, respectively for the three month periods ending September 30, 2007 and 2006.



Index

- Net Interest Margin

The net interest margin for the three months ended September 30, 2007 was 3.39% compared to 3.25% for the three months ended September 30, 2006. The ratio is calculated by dividing net interest income by average earning assets. Earning assets are primarily made up of loans and investments that earn interest. This ratio is used to measure how well the Company is able to maintain interest rates on earning assets above those of interest-bearing liabilities, which is the interest expense paid on deposits and other borrowings. The Company's net interest margin improved when compared to September 30, 2006 and is in line with the industry average for 2007.

- Efficiency Ratio

This ratio is calculated by dividing noninterest expense by net interest income and noninterest income. The ratio is a measure of the Company's ability to manage noninterest expenses. The Company's efficiency ratio compares favorably to the industry's average and was 54.02% and 52.80% for the three months ended September 30, 2007 and 2006, respectively.

- Capital Ratio

The average capital ratio is calculated by dividing average total equity capital by average total assets. It measures the level of average assets that are funded by shareholders' equity. Given an equal level of risk in the financial condition of two companies, the higher the capital ratio, generally the more financially sound the company. The Company's capital ratio is significantly higher than the industry average.

## Industry Results

The FDIC Quarterly Banking Profile reported the following results for the second quarter of 2007:

Industry earnings remained strong in the second quarter of 2007, despite an operating environment that was decidedly less favorable than in earlier quarters. A flat yield curve, rising levels of troubled loans, and a weak housing market all made the task of improving earnings more difficult. Insured commercial banks and savings institutions reported \$36.7 billion in net income for the quarter, a decline of \$1.3 billion (3.4%) from the second quarter of 2006, but \$772 million (2.1%) more than they earned in the first quarter of 2007. The decline in earnings compared to a year ago was caused by higher provisions for loan losses, particularly at larger institutions, and by increased noninterest expenses. The impact of these higher costs was partly offset by increased noninterest income and net interest income. For the second consecutive quarter, fewer than half of all insured institutions reported higher quarterly earnings than a year earlier. The average return on assets (ROA) for the second quarter was 1.21%, down from 1.34% in the second quarter of 2006. More than half of all institutions (59%) reported lower ROAs than a year earlier. There were 824 institutions reporting net losses for the quarter, compared to 600 unprofitable institutions a year earlier. This is the largest year-over-year increase in unprofitable institutions since the third quarter of 1996. The increase in unprofitable institutions was greatest among institutions with less than \$1 billion in assets, and among institutions with high levels of residential real estate and commercial loan exposures. The proportion of unprofitable institutions, (9.6%) of all insured institutions, was the highest level for a second quarter since 1991. More than half of the unprofitable institutions (52.2%) were less than five years old.

Insured institutions added \$11.4 billion in provisions for loan losses to their reserves during the second quarter, the largest quarterly loss provision for the industry since the fourth quarter of 2002. This was \$4.9 billion (75.3%) more than they set aside in the second quarter of 2006. At institutions with assets greater than \$1 billion, loss provisions absorbed 7.7% of net operating revenue (net interest income plus total noninterest income); a year earlier, provisions siphoned off only 4.5% of revenue. Noninterest expenses were \$5.6 billion (6.6%) higher than a year earlier. Spending

for salaries and other employee benefits was up by \$3.5 billion (9.1%). The greatest positive contribution to earnings came from noninterest income, which grew by \$5.6 billion (9.0%). The improvement in noninterest income was led by higher trading revenue (up \$1.4 billion, or 28.5%), increased servicing income (up \$1.1 billion, or 25.1%), and increased fiduciary income (up \$1.0 billion, or 15.8%, at institutions filing Call Reports).

**Index**

**Income Statement Review**

The following highlights a comparative discussion of the major components of net income and their impact for the three month periods ended September 30, 2007 and 2006:

**Critical Accounting Policies**

The discussion contained in this Item 2 and other disclosures included within this report are based, in part, on the Company's audited consolidated financial statements. These statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The financial information contained in these statements is, for the most part, based on the financial effects of transactions and events that have already occurred. However, the preparation of these statements requires management to make certain estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses.

The Company's significant accounting policies are described in the "Notes to Consolidated Financial Statements" contained in the Company's 10-K. Based on its consideration of accounting policies that involve the most complex and subjective estimates and judgments, management has identified its most critical accounting policy to be that related to the allowance for loan losses.

The allowance for loan losses is established through a provision for loan losses that is treated as an expense and charged against earnings. Loans are charged against the allowance for loan losses when management believes that collectibility of the principal is unlikely. The Company has policies and procedures for evaluating the overall credit quality of its loan portfolio, including timely identification of potential problem loans. On a quarterly basis, management reviews the appropriate level for the allowance for loan losses incorporating a variety of risk considerations, both quantitative and qualitative. Quantitative factors include the Company's historical loss experience, delinquency and charge-off trends, collateral values, known information about individual loans and other factors. Qualitative factors include the general economic environment in the Company's market area. To the extent actual results differ from forecasts and management's judgment, the allowance for loan losses may be greater or lesser than future charge-offs.

**Index****AVERAGE BALANCES AND INTEREST RATES**

The following two tables are used to calculate the Company's net interest margin. The first table includes the Company's average assets and the related income to determine the average yield on earning assets. The second table includes the average liabilities and related expense to determine the average rate paid on interest bearing liabilities. The net interest margin is equal to the interest income less the interest expense divided by average earning assets.

**AVERAGE BALANCE SHEETS AND INTEREST RATES**

Three Months Ended September 30,

| ASSETS<br>(dollars in thousands) | Average<br>balance | 2007<br>Revenue/<br>expense | Yield/<br>rate | Average<br>balance | 2006<br>Revenue/<br>expense | Yield/<br>rate |
|----------------------------------|--------------------|-----------------------------|----------------|--------------------|-----------------------------|----------------|
| Interest-earning assets          |                    |                             |                |                    |                             |                |
| Loans (1)                        |                    |                             |                |                    |                             |                |
| Commercial                       | \$ 79,248          | \$ 1,584                    | 8.00%          | \$ 70,593          | \$ 1,427                    | 8.09%          |
| Agricultural                     | 31,873             | 688                         | 8.63%          | 33,813             | 727                         | 8.60%          |
| Real estate                      | 325,532            | 5,414                       | 6.65%          | 305,662            | 4,979                       | 6.52%          |
| Installment and other            | 21,973             | 376                         | 6.84%          | 23,846             | 372                         | 6.24%          |
| Total loans (including fees)     | \$ 458,626         | \$ 8,062                    | 7.03%          | \$ 433,914         | \$ 7,505                    | 6.92%          |
| Investment securities            |                    |                             |                |                    |                             |                |
| Taxable                          | \$ 202,803         | \$ 2,458                    | 4.85%          | \$ 218,684         | \$ 2,409                    | 4.41%          |
| Tax-exempt (2)                   | 138,165            | 2,266                       | 6.56%          | 121,696            | 1,962                       | 6.45%          |
| Total investment securities      | \$ 340,968         | \$ 4,724                    | 5.54%          | \$ 340,380         | \$ 4,371                    | 5.14%          |
| Interest bearing                 |                    |                             |                |                    |                             |                |
| deposits with banks              | \$ 767             | \$ 8                        | 4.17%          | \$ 3,921           | \$ 35                       | 3.57%          |
| Federal funds sold               | 56                 | 2                           | 14.29%         | 2,853              | 41                          | 5.75%          |
| Total interest-earning assets    | \$ 800,417         | \$ 12,796                   | 6.39%          | \$ 781,068         | \$ 11,952                   | 6.12%          |
| Non-interest-earning assets      |                    |                             |                |                    |                             |                |
|                                  | 42,516             |                             |                | 35,605             |                             |                |
| TOTAL ASSETS                     | \$ 842,933         |                             |                | \$ 816,673         |                             |                |

1 Average loan balances include nonaccrual loans, if any. Interest income collected on nonaccrual loans has been included.

2 Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental tax rate of 35%.



**Index**

## AVERAGE BALANCE SHEETS AND INTEREST RATES

Three Months Ended September 30,

| LIABILITIES AND<br>STOCKHOLDERS'<br>EQUITY<br>(dollars in thousands) | 2007               |                     |                | 2006               |                     |                |
|--|--------------------|---------------------|----------------|--------------------|---------------------|----------------|
|  | Average<br>balance | Revenue/<br>expense | Yield/<br>rate | Average<br>balance | Revenue/<br>expense | Yield/<br>rate |
| Interest-bearing<br>liabilities                                      |                    |                     |                |                    |                     |                |
| Deposits   |                    |                     |                |                    |                     |                |
| Savings, NOW<br>accounts, and money<br>markets                       | \$ 290,779         | \$ 1,762            | 2.42%          | \$ 307,788         | \$ 2,165            | 2.81%          |
| Time deposits <<br>\$100,000   | 178,839            | 2,037               | 4.56%          | 182,885            | 1,837               | 4.02%          |
| Time deposits ><br>\$100,000   | 114,533            | 1,434               | 5.01%          | 95,887             | 1,109               | 4.63%          |
| Total deposits   | \$ 584,151         | \$ 5,233            | 3.58%          | \$ 586,560         | \$ 5,111            | 3.49%          |
| Other borrowed funds   | 67,904             | 789                 | 4.65%          | 42,953             | 498                 | 4.64%          |
| Total interest-bearing<br>liabilities                                | \$ 652,055         | \$ 6,022            | 3.69%          | \$ 629,513         | \$ 5,609            | 3.56%          |
| Non-interest-bearing<br>liabilities                                  |                    |                     |                |                    |                     |                |
| Demand deposits  | \$ 73,338          |                     |                | \$ 71,010          |                     |                |
| Other liabilities  | 7,539              |                     |                | 7,345              |                     |                |
| Stockholders' equity   | \$ 110,001         |                     |                | \$ 108,805         |                     |                |
| TOTAL LIABILITIES<br>AND<br>STOCKHOLDERS'<br>EQUITY                  | \$ 842,933         |                     |                | \$ 816,673         |                     |                |
| Net interest: income /<br>margin                                     |                    | \$ 6,774            | 3.39%          |                    | \$ 6,343            | 3.25%          |
| Spread Analysis  |                    |                     |                |                    |                     |                |
| Interest income/average<br>assets                                    | \$ 12,796          | 6.07%               |                | \$ 11,952          | 5.85%               |                |
| Interest<br>expense/average assets                                   | 6,022              | 2.86%               |                | 5,609              | 2.75%               |                |
| Net interest<br>income/average assets                                | 6,774              | 3.21%               |                | 6,343              | 3.11%               |                |



**Index**

Net Interest Income

For the three months ended September 30, 2007 and 2006, the Company's net interest margin adjusted for tax exempt income was 3.39% and 3.25%, respectively. Net interest income, prior to the adjustment for tax-exempt income, for the three months ended September 30, 2007 and September 30, 2006 totaled \$5,981,000 and \$5,656,000, respectively.

For the quarter ended September 30, 2007, net interest income increased \$325,000 or 6% when compared to the same period in 2006. Interest income increased \$738,000 or 7% over that same time frame. The increase in interest income was primarily attributable to improved loan and investment yields and volume.

Interest expense increased \$414,000 or 7% for the quarter ended September 30, 2007 when compared to the same period in 2006. The higher interest expense for the quarter is primarily attributable to a higher volume and rate on interest bearing liabilities as market interest rates increased from one year ago.

Provision for Loan Losses

The Company's credit for loan losses for the three months ended September 30, 2007 was \$264,000 compared to a provision of \$46,000 during the same period last year.

Non-interest Income and Expense

Non-interest income for this quarter increased \$417,000, or 27%, as the result of higher trust department income and increased net securities gains on the Company's investment portfolio.

Non-interest expense was 13% higher in the third quarter of 2007 as the result of a \$233,000 provision expense to increase the reserve for off balance sheet liabilities and the initial costs of employee salaries and benefits associated with the opening of First National Bank's Ankeny office. No losses have occurred during the quarter relating to off balance sheet liabilities. The efficiency ratio for the three months ended September 30, 2007 and 2006 was 54.02% and 52.80%, respectively.

Income Taxes

The provision for income taxes for September 30, 2007 and September 30, 2006 was \$990,000 and \$820,000, respectively. This amount represents an effective tax rate of 25% for the three months ended September 30, 2007 versus 24% for the same quarter in 2006. The Company's marginal federal tax rate is currently 35%. The difference between the Company's effective and marginal tax rate is primarily related to investments made in tax exempt securities.



**Index****Income Statement Review for Nine Months Ended September 30, 2007**

The following highlights a comparative discussion of the major components of net income and their impact for the nine months ended September 30, 2007 and 2006:

**AVERAGE BALANCES AND INTEREST RATES**

The following two tables are used to calculate the Company's net interest margin. The first table includes the Company's average assets and the related income to determine the average yield on earning assets. The second table includes the average liabilities and related expense to determine the average rate paid on interest bearing liabilities. The net interest margin is equal to the interest income less the interest expense divided by average earning assets.

**ASSETS**

(dollars in thousands)

**AVERAGE BALANCE SHEETS AND INTEREST RATES**

|   | Nine Months Ended September 30, |                      |            |                   |                      |            |
|---|---------------------------------|----------------------|------------|-------------------|----------------------|------------|
|   | Average balance                 | 2007 Revenue/expense | Yield/rate | Average balance   | 2006 Revenue/expense | Yield/rate |
| <b>Loans (1)</b>                        |                                 |                      |            |                   |                      |            |
| Commercial                              | \$ 77,569                       | \$ 4,643             | 7.98%      | \$ 70,619         | \$ 4,031             | 7.61%      |
| Agricultural                            | 32,079                          | 2,047                | 8.51%      | 33,345            | 2,058                | 8.23%      |
| Real estate                             | 317,712                         | 15,676               | 6.58%      | 307,917           | 14,661               | 6.35%      |
| Installment and other                   | 22,746                          | 1,134                | 6.65%      | 28,719            | 1,314                | 6.10%      |
| Total loans (including fees)            | \$ 450,106                      | \$ 23,500            | 6.96%      | \$ 440,600        | \$ 22,064            | 6.68%      |
| <b>Investment securities</b>            |                                 |                      |            |                   |                      |            |
| Taxable                                 | \$ 208,004                      | \$ 7,365             | 4.72%      | \$ 211,711        | \$ 6,750             | 4.25%      |
| Tax-exempt (2)                          | 136,721                         | 6,706                | 6.54%      | 122,100           | 5,853                | 6.39%      |
| Total investment securities             | \$ 344,725                      | \$ 14,071            | 8.16%      | \$ 333,811        | \$ 12,603            | 5.03%      |
| <b>Interest bearing</b>                 |                                 |                      |            |                   |                      |            |
| deposits with banks                     | \$ 942                          | \$ 33                | 4.67%      | \$ 4,534          | \$ 108               | 3.18%      |
| Federal funds sold                      | 4,762                           | 182                  | 5.10%      | 3,672             | 145                  | 5.27%      |
| Total interest-earning assets           | \$ 800,535                      | \$ 37,786            | 6.29%      | \$ 782,617        | \$ 34,920            | 5.95%      |
| <b>Total noninterest-earning assets</b> |                                 |                      |            |                   |                      |            |
|   | \$ 44,071                       |                      |            | \$ 33,738         |                      |            |
| <b>TOTAL ASSETS</b>                     | <b>\$ 844,606</b>               |                      |            | <b>\$ 816,355</b> |                      |            |

1 Average loan balance include nonaccrual loans, if any. Interest income collected on nonaccrual loans has been included.

2 Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental tax rate of 35%.

16

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**Index**
**LIABILITIES AND  
STOCKHOLDERS'  
EQUITY**  
(dollars in thousands)

**AVERAGE BALANCE SHEETS AND INTEREST RATES**

|   | Nine Months Ended September 30, |                             |                |                    |                             |                |
|---|---------------------------------|-----------------------------|----------------|--------------------|-----------------------------|----------------|
|   | Average<br>balance              | 2007<br>Revenue/<br>expense | Yield/<br>rate | Average<br>balance | 2006<br>Revenue/<br>expense | Yield/<br>rate |
| <b>Interest-bearing liabilities</b>               |                                 |                             |                |                    |                             |                |
| <b>Deposits</b>                                   |                                 |                             |                |                    |                             |                |
| Savings, NOW accounts, and money markets          | \$ 311,610                      | \$ 6,078                    | 2.60%          | \$ 316,359         | \$ 6,144                    | 2.59%          |
| Time deposits < \$100,000                         | 180,233                         | 5,967                       | 4.41%          | 181,984            | 5,158                       | 3.78%          |
| Time deposits > \$100,000                         | 107,932                         | 3,997                       | 4.94%          | 98,794             | 3,214                       | 4.34%          |
| Total deposits                                    | \$ 599,775                      | \$ 16,042                   | 3.57%          | \$ 597,137         | \$ 14,516                   | 3.24%          |
| Other borrowed funds                              | 53,214                          | 1,804                       | 4.52%          | 34,911             | 1,097                       | 4.19%          |
| Total interest-bearing liabilities                | \$ 652,989                      | \$ 17,846                   | 3.64%          | \$ 632,048         | \$ 15,613                   | 3.29%          |
| <b>Noninterest-bearing liabilities</b>            |                                 |                             |                |                    |                             |                |
| Demand deposits                                   | \$ 72,417                       |                             |                | \$ 69,520          |                             |                |
| Other liabilities                                 | 7,814                           |                             |                | 6,027              |                             |                |
| Stockholders' equity                              | \$ 111,386                      |                             |                | \$ 108,760         |                             |                |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                                 |                             |                |                    |                             |                |
|   | \$ 844,606                      |                             |                | \$ 816,355         |                             |                |
| <b>Net interest income / margin</b>               |                                 |                             |                |                    |                             |                |
|   |                                 | \$ 19,940                   | 3.32%          |                    | \$ 19,307                   | 3.29%          |
| <b>Spread Analysis</b>                            |                                 |                             |                |                    |                             |                |
| Interest income/average assets                    |                                 | \$ 37,786                   | 5.97%          |                    | \$ 34,920                   | 5.70%          |
| Interest expense/average assets                   |                                 | 17,846                      | 2.82%          |                    | 15,613                      | 2.55%          |
| Net interest income/average assets                |                                 | 19,940                      | 3.15%          |                    | 19,307                      | 3.15%          |



**Index**

Net Interest Income

For the nine months ended September 30, 2007 and 2006, the Company's net interest margin adjusted for tax exempt income was 3.32% and 3.29%, respectively. Net interest income, prior to the adjustment for tax-exempt income, for the nine months ended September 30, 2007 compared to the same period in 2006 was \$334,000 higher and totaled \$17,593,000 and \$17,259,000, respectively.

For the nine months ended September 30, 2007, interest income increased \$2,567,000 or 8% when compared to the same period in 2006. The increase was primarily attributable to higher loan and investment yields and volumes than the nine months ended September 30, 2006.

Interest expense increased \$2,233,000 or 14% for the nine months ended September 30, 2007 when compared to the same period in 2006. The higher interest expense for the period is attributable to a higher average rates and increased volumes of deposits and other borrowings as short term market interest rates have increased in comparison to the same period in 2006.

Provision for Loan Losses

The Company's recorded a credit for loan losses for the first three quarters of this year of \$111,000 compared to a credit of \$227,000 for the nine months ended September 30, 2006. Net loan recoveries of \$242,000 were realized in the nine months ended September 30, 2007 and compare to net charge-offs of \$35,000 for the nine months ended September 30, 2006.

Non-interest Income and Expense

Non-interest income increased \$704,000, or 14% during the nine months ended September 30, 2007 compared to the same period in 2006 as the result of higher trust department income and increased net securities gains on the Company's investment portfolio. Trust revenues had a one-time increase of approximately \$275,000 in the second quarter of 2007.

Non-interest expense increased \$864,000 or 7% for the first nine months of 2007 compared to the same period in 2006 primarily as the result of the initial costs of employee salaries and benefits associated with the opening of First National Bank's Ankeny office and the provision of \$233,000 to provide additional reserves for off balance sheet commitments, primarily unfunded lines of credit on loans. No losses have occurred in 2007 relating to off balance sheet liabilities.

Income Taxes

The provision for income taxes for the nine months ended September 30, 2007 and 2006 was \$2,651,000 and \$2,658,000, respectively. These amounts represent an effective tax rate of 24% for both periods. The Company's marginal federal tax rate is currently 35%. The difference between the Company's effective and marginal tax rate is primarily related to investments made in tax exempt securities.

**Balance Sheet Review**

As of September 30, 2007, total assets were \$851,293,000, a \$12,440,000 increase compared to December 31, 2006. The most significant balance sheet changes since December 31, 2006 were investments and federal funds sold being reinvested in the loan portfolio.



**Index**

Investment Portfolio

The investment portfolio totaled \$341,090,000 as of September 30, 2007, 4% lower than the December 31, 2006 balance of \$354,572,000.

Loan Portfolio

Loan volume grew \$28,741,000, or 7%, during the first nine months as net loans totaled \$457,864,000 as of September 30, 2007 compared to \$429,123,000 as of December 31, 2006. Loan growth was primarily in the commercial and commercial real estate portfolios.

Deposits

Deposits totaled \$650,980,000 as of September 30, 2007, a 4% decrease totaling \$29,377,000 from December 31, 2006. Demand, interest checking (NOW), and savings and money market balances were down 8% to 9% from year end. Deposit balances were down 1% from September 30, 2006.

Other Borrowed Funds

Other borrowed funds as of September 30, 2007 totaled \$81,594,000 compared to the December 31, 2006 total of \$38,198,000. This increase was primarily the result of additional federal funds purchased and repurchase agreements reflected in long-term borrowings with maturities ranging from two through five years.

Off-Balance Sheet Arrangements

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. No material changes in the Company's off-balance sheet arrangements have occurred since December 31, 2006.

**Asset Quality Review and Credit Risk Management**

The Company's credit risk is centered in the loan portfolio, which on September 30, 2007 totaled \$457,864,000 compared to \$429,123,000 as of December 31, 2006. Net loans comprise 54% of total assets as of September 30, 2007. The object in managing loan portfolio risk is to reduce the risk of loss resulting from a customer's failure to perform according to the terms of a transaction and to quantify and manage credit risk on a portfolio basis. The Company's level of impaired loans consisting of non-accrual loans and loans past due 90 days or more as a percentage of total loans of 0.35% is below that of the Company's peer group of 416 bank holding companies with assets of \$500 million to \$1 billion as of June 30, 2007 of 0.72%.

Impaired loans totaled \$2,982,000 as of September 30, 2007 compared to \$1,049,000 as of December 31, 2006. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Impaired loans generally include loans accounted for on a non-accrual basis, accruing loans which are contractually past due 90 days or more as to principal or interest payments, and any restructured loans. As of September 30, 2007, non-accrual loans totaled \$2,539,000, loans past due 90 days still accruing totaled \$443,000 and there were no restructured loans outstanding. Other real estate owned totaled \$2,846,000 as of September 30, 2007 and \$2,808,000 as of December 31, 2006.

The allowance for loan losses as a percentage of outstanding loans as of September 30, 2007 and December 31, 2006 was 1.33% and 1.50%, respectively. The allowance for loan and lease losses totaled \$6,181,000 and \$6,533,000 as of September 30, 2007 and December 31, 2006, respectively. Net loan charge-offs for the most recent quarter end totaled \$245,000 compared to net charge-offs of loans of \$11,000 for the three month period ended September 30, 2006.



**Index**

The allowance for loan losses is management’s best estimate of probable losses inherent in the loan portfolio as of the balance sheet date. Factors considered in establishing an appropriate allowance include: an assessment of the financial condition of the borrower, a realistic determination of value and adequacy of underlying collateral, the condition of the local economy and the condition of the specific industry of the borrower, an analysis of the levels and trends of loan categories and a review of delinquent and classified loans.

**Liquidity and Capital Resources**

Liquidity management is the process by which the Company, through its Banks’ Asset and Liability Committees (ALCO), ensures that adequate liquid funds are available to meet its financial commitments on a timely basis, at a reasonable cost and within acceptable risk tolerances. These commitments include funding credit obligations to borrowers, funding of mortgage originations pending delivery to the secondary market, withdrawals by depositors, maintaining adequate collateral for pledging for public funds, trust deposits and borrowings, paying dividends to shareholders, payment of operating expenses, funding capital expenditures and maintaining deposit reserve requirements.

Liquidity is derived primarily from core deposit growth and retention; principal and interest payments on loans; principal and interest payments, sale, maturity and prepayment of investment securities; net cash provided from operations; and access to other funding sources. Other funding sources include federal funds purchased lines, securities sold under agreements to repurchase (repurchase agreements), Federal Home Loan Bank (FHLB) advances and other capital market sources.

As of September 30, 2007, the level of liquidity and capital resources of the Company remain at a satisfactory level and compare favorably to that of other FDIC insured institutions. Management believes that the Company’s liquidity sources will be sufficient to support its existing operations for the foreseeable future.

The liquidity and capital resources discussion will cover the following topics:

- Review the Company’s Current Liquidity Sources
  - Review of the Statements of Cash Flows
    - Company Only Cash Flows
- Review of Commitments for Capital Expenditures, Cash Flow Uncertainties and Known Trends in Liquidity and Cash Flows Needs
  - Capital Resources

**Review of the Company’s Current Liquidity Sources**

Liquid assets of cash on hand, balances due from other banks, federal funds sold and interest-bearing deposits in financial institutions for September 30, 2007 and December 31, 2006 totaled \$26,316,000 and \$31,154,000, respectively. Federal funds sold being used to fund loan growth is the primary reason for the lower liquidity levels as of September 30, 2007.

Other sources of liquidity available to the Banks as of September 30, 2007 include outstanding lines of credit with the Federal Home Loan Bank of Des Moines, Iowa of \$46,840,000 and federal funds borrowing capacity at correspondent banks of \$99,500,000. The Company had federal funds purchased of \$15,900,000, daily repurchase agreements totaling \$39,332,000, other short term borrowing of \$3,362,000, term repurchase agreements totaling \$20,000,000 and FHLB advances of \$3,000,000 as of September 30, 2007.



**Index**

Total investments as of September 30, 2007 were \$341,090,000 compared to \$354,572,000 as of year-end 2006. These investments provide the Company with a significant amount of liquidity since all of the investments are classified as available for sale as of September 30, 2007.

The investment portfolio serves an important role in the overall context of balance sheet management in terms of balancing capital utilization and liquidity. The decision to purchase or sell securities is based upon the current assessment of economic and financial conditions, including the interest rate environment, liquidity and credit considerations. The portfolio's scheduled maturities represent a significant source of liquidity.

**Review of Statements of Cash Flows**

Operating cash flows for September 30, 2007 and 2006 totaled \$7,280,000 and \$8,162,000, respectively. The primary variance in operating cash flows for the first nine months of 2007 compared to the same period one year ago relates to a lower source of funds as a result of subtracting security gains and the use of cash to fund loans held for sale. The variance in operating cash flows relating accrued income receivable and accrued expenses largely offset each other in comparing the two year operating results.

Net cash used in investing activities through September 30, 2007 was \$4,712,000 compared to a source of funds from investing of \$1,748,000 for nine month period ending September 30, 2006. Additional growth in the loan portfolio was the most significant use of cash for investing in the first nine months of 2007 as investments and federal funds sold were the source of cash utilized to fund the loan growth.

Net cash provided by financing activities for September 30, 2007 totaled \$6,577,000 compared to a use of cash of \$9,987,000 for the nine month period in 2006. A higher level of federal funds purchased and other borrowings were the largest use of financing cash flows for the nine months ended September 30, 2007. A decrease in deposits partially offset by higher federal funds purchased and repurchase agreements was the most significant factor in 2006. As of September 30, 2007, the Company did not have any external debt financing, off balance sheet financing arrangements, or derivative instruments linked to its stock.

**Company Only Cash Flows**

The Company's liquidity on an unconsolidated basis is heavily dependent upon dividends paid to the Company by the Banks. The Company requires adequate liquidity to pay its expenses and pay stockholder dividends. For the nine months ended September 30, 2007, dividends paid by the Banks to the Company amounted to \$6,633,000 compared to \$6,551,000 for the same period in 2006. In 2006, dividends paid by the Banks to the Company amounted to \$8,734,000 through December 31, 2006 compared to \$8,634,000 for the year ended December 31, 2005. Various federal and state statutory provisions limit the amounts of dividends banking subsidiaries are permitted to pay to their holding companies without regulatory approval. Federal Reserve policy further limits the circumstances under which bank holding companies may declare dividends. For example, a bank holding company should not continue its existing rate of cash dividends on its common stock unless its net income is sufficient to fully fund each dividend and its prospective rate of earnings retention appears consistent with its capital needs, asset quality and overall financial condition. In addition, the Federal Reserve and the FDIC have issued policy statements, which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings. Federal and state banking regulators may also restrict the payment of dividends by order.

The Company has unconsolidated interest bearing deposits and marketable investment securities totaling \$35,529,000 that are presently available to provide additional liquidity to the Banks.

Review of Commitments for Capital Expenditures, Cash Flow Uncertainties and Known Trends in Liquidity and Cash Flows Needs

No material capital expenditures or material changes in the capital resource mix are anticipated at this time. The primary cash flow uncertainty would be a sudden decline in deposits causing the Banks to liquidate securities. Historically, the Banks have maintained an adequate level of short term marketable investments to fund the temporary declines in deposit balances. There are no known trends in liquidity and cash flows needs as of September 30, 2007 that is a concern to management.

**Index**

Capital Resources

The Company's total stockholders' equity as of September 30, 2007 totaled \$111,618,000 and was 1% lower than the \$112,923,000 recorded as of December 31, 2006. At September 30, 2007 and December 31, 2006, stockholders' equity as a percentage of total assets was 13.11% and 13.46%, respectively. The capital levels of the Company currently exceed applicable regulatory guidelines as of September 30, 2007.

**Forward-Looking Statements and Business Risks**

The discussion in the foregoing Management Discussion and Analysis and elsewhere in this Report contains forward-looking statements about the Company, its business and its prospects. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include use of the words "believe", "expect", "anticipate", "intend", "plan", "estimate" or words of similar meaning, or future or conditional verbs such as "will", "would", "should", "could" or "may". Forward-looking statements, by their nature, are subject to risks and uncertainties. A number of factors, many of which are beyond the Company's control, could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. Such risks and uncertainties with respect to the Company include, but are not limited to, those related to the economic conditions, particularly in the areas in which the Company and the Banks operate, competitive products and pricing, fiscal and monetary policies of the U.S. government, changes in governmental regulations affecting financial institutions (including regulatory fees and capital requirements), changes in prevailing interest rates, credit risk management and asset/liability management, the financial and securities markets and the availability of and costs associated with sources of liquidity.

These factors may not constitute all factors that could cause actual results to differ materially from those discussed in any forward-looking statement. The Company operates in a continually changing business environment and new facts emerge from time to time. It cannot predict such factors nor can it assess the impact, if any, of such factors on its financial position or its results of operations. Accordingly, forward-looking statements should not be relied upon as a predictor of actual results. The Company disclaims any responsibility to update any forward-looking statement provided in this document.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's market risk is comprised primarily of interest rate risk arising from its core banking activities of lending and deposit taking. Interest rate risk results from the changes in market interest rates which may adversely affect the Company's net interest income. Management continually develops and applies strategies to mitigate this risk. Management does not believe that the Company's primary market risk exposure and how it has been managed to-date in 2007 changed significantly when compared to 2006.

Item 4. Controls and Procedures

An evaluation was performed under the supervision and with the participation of the Company's management, including the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of September 30, 2007. Based on that evaluation, the Company's management, including the Principal Executive Officer and Principal Financial Officer, concluded that the Company's disclosure controls and procedures were effective. There have been no significant changes in the Company's disclosure controls or its internal controls over financial reporting, or in other factors that could significantly affect the disclosure controls or the Company's internal controls over financial reporting.



**Index**

Changes in Internal Controls

There was no change in the Company's internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) of the Exchange Act that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable

Item 1.a. Risk Factors

No changes

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

(a) Exhibits

31.1 Certification of Principal Executive Officer Pursuant to Section 302 of Sarbanes-Oxley Act of 2002.

31.2 Certification of Principal Financial Officer Pursuant to Section 302 of Sarbanes-Oxley Act of 2002.

32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350.

32.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350.

*Index*

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AMES NATIONAL CORPORATION

DATE: November 8, 2007

By: */s/ Thomas H. Pohlman*

Thomas H. Pohlman, President  
Principal Executive Officer

By: */s/ John P. Nelson*

John P. Nelson, Vice President  
Principal Financial Officer