AMES NATIONAL CORP
Form 10-Q
November 10, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[Mark One]

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

For the quarterly period ended September 30, 2008

o 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	42-1039071
(State or Other Jurisdiction of Incorporation or Organization)	(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 x No o

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 o Accelerated filer x Non-accelerated filer o Smaller reporting company o

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

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	9,432,915
(Class)	(Shares Outstanding at November 3, 2008)

AMES NATIONAL CORPORATION

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AMES NATIONAL CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets
(unaudited)

ASSETS		September 30, 2008		December 31, 2007
Cash and due from banks	$	27,216,295	$	26,044,577
Federal funds sold		-		5,500,000
Interest bearing deposits in financial institutions		7,550,340		634,613
Securities available-for-sale		323,416,226		339,942,064
Loans receivable, net		446,224,818		463,651,000
Loans held for sale		1,169,084		344,970
Bank premises and equipment, net		12,785,372		13,446,865
Other real estate owned		12,648,962		2,845,938
Accrued income receivable		7,723,433		8,022,900
Deferred income taxes		7,263,335		929,326
Other assets		473,967		228,895
Total assets	$	846,471,832	$	861,591,148
LIABILITIES AND STOCKHOLDERS' EQUITY				
LIABILITIES				
Deposits				
Demand, noninterest bearing	$	79,518,096	$	80,638,995
NOW accounts		155,448,377		160,672,326
Savings and money market		161,470,338		162,291,544
Time, $100,000 and over		85,408,343		109,189,660
Other time		165,418,906		177,326,270
Total deposits		647,264,060		690,118,795
Federal funds purchased and securities sold under agreementsto repurchase		47,258,710		30,033,321
Other short-term borrowings		1,089,061		737,420
Long-term borrowings		39,500,000		24,000,000
Dividend payable		2,641,216		2,545,987
Accrued expenses and other liabilities		4,967,463		4,135,102
Total liabilities		742,720,510		751,570,625
STOCKHOLDERS' EQUITY				
Common stock, $2 par value, authorized 18,000,000 shares; 9,432,915 and 9,429,580 shares issued and outstanding at September 30, 2008and December 31, 2007, respectively		18,865,830		18,859,160
Additional paid-in capital		22,651,222		22,588,691
Retained earnings		63,535,036		66,683,016
Accumulated other comprehensive income (loss)-net unrealized gain (loss) on securities available-for-sale		(1,300,766)		1,889,656
Total stockholders' equity		103,751,322		110,020,523
Total liabilities and stockholders' equity	$	846,471,832	$	861,591,148

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AMES NATIONAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Interest and dividend income:				
Loans	$ 7,237,129	$ 8,062,624	$ 22,386,655	$ 23,500,424
Securities				
Taxable	2,497,103	2,322,438	7,487,230	6,981,845
Tax-exempt	1,201,777	1,218,921	3,809,905	3,603,235
Federal funds sold	15,835	2,132	150,284	181,523
Dividends	229,216	397,137	898,953	1,171,687
Total interest income	11,181,060	12,003,252	34,733,027	35,438,714
Interest expense:				
Deposits	3,289,349	5,232,913	11,363,993	16,041,795
Other borrowed funds	557,783	789,136	1,687,382	1,804,055
Total interest expense	3,847,132	6,022,049	13,051,375	17,845,850
Net interest income	7,333,928	5,981,203	21,681,652	17,592,864
Provision (credit) for loan losses	73,514	(264,131)	1,002,208	(110,527)
Net interest income after provision (credit) for loan losses	7,260,414	6,245,334	20,679,444	17,703,391
Non-interest income:				
Trust department income	391,115	438,383	1,222,268	1,543,048
Service fees	451,162	479,930	1,332,094	1,383,137
Securities gains (losses), net	(5,487,250)	537,969	(6,900,899)	1,444,047
Gain on sale of loans held for sale	217,928	241,548	604,467	539,652
Merchant and ATM fees	169,512	143,859	483,515	426,144
Other	143,802	146,284	520,704	430,943
Total non-interest income (loss)	(4,113,731)	1,987,973	(2,737,851)	5,766,971
Non-interest expense:				
Salaries and employee benefits	2,647,502	2,480,547	7,728,417	7,543,814
Data processing	511,166	535,527	1,681,526	1,643,884
Occupancy expenses	397,897	344,227	1,203,963	965,715
Provision for off-balance sheet commitments	4,000	233,000	15,000	233,000
Other operating expenses	773,195	711,887	2,230,776	2,146,260
Total non-interest expense	4,333,760	4,305,188	12,859,682	12,532,673

Income before income taxes		(1,187,077)		3,928,119		5,081,911		10,937,689
Income tax expense (credit)		(1,193,983)		989,580		307,176		2,650,706
Net income	$	6,906	$	2,938,539	$	4,774,735	$	8,286,983
Basic and diluted earnings per share	$	0.00	$	0.31	$	0.51	$	0.88
Declared dividends per share	$	0.28	$	0.27	$	0.84	$	0.81
Comprehensive income (loss)	$	(509,449)	$	4,091,849	$	1,584,313	$	6,232,334

AMES NATIONAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows
(unaudited)

	Nine Months Ended September 30,	
	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 4,774,735	$ 8,286,983
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision (credit) for loan losses	1,002,208	(110,527)
Provision for off-balance sheet commitments	15,000	233,000
Amortization and accretion	(160,936)	(162,610)
Depreciation	832,365	788,951
Provision (credit) for deferred taxes	(4,460,270)	5,264
Securities losses (gains), net	6,900,899	(1,444,047)
Change in assets and liabilities:		
Decrease in loans held for sale	(824,114)	(228,434)
Increase (decrease) in accrued income receivable	299,467	(537,536)
Increase in other assets	(245,072)	(136,900)
Increase in accrued expenses and other liabilities	817,361	585,657
Net cash provided by operating activities	8,951,643	7,279,801
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of securities available-for-sale	(122,947,883)	(46,780,067)
Proceeds from sale of securities available-for-sale	54,824,181	6,076,548
Proceeds from maturities and calls of securities available-for-sale	72,845,415	52,530,817
Net decrease (increase) in interest bearing deposits in financial institutions	(6,915,727)	882,421
Net decrease in federal funds sold	5,500,000	13,100,000
Net decrease (increase) in loans	6,620,950	(28,631,293)
Purchase of bank premises and equipment	(170,872)	(1,890,880)
Net cash provided by (used in) investing activities	9,756,064	(4,712,454)
CASH FLOWS FROM FINANCING ACTIVITIES		
Decrease in deposits	(42,854,735)	(29,376,571)
Increase in federal funds purchased and securities sold under agreements to repurchase	17,225,389	20,504,318
Increase in other borrowings, net	15,851,641	22,891,419
Dividends paid	(7,827,485)	(7,541,244)
Proceeds from issuance of common stock	69,201	98,921
Net cash provided by (used in) financing activities	(17,535,989)	6,576,843
Net increase in cash and cash equivalents	1,171,718	9,144,190

CASH AND DUE FROM BANKS				
Beginning		26,044,577		16,510,082
Ending	$	27,216,295	$	25,654,272
Cash payments for:				
Interest	$	14,052,327	$	17,688,771
Income taxes		3,737,210		2,526,719
Noncash transfer of loans to other real estate owned	$	9,803,024	$	37,477

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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, 2008 and 2007 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. Certain immaterial reclassifications have been made to previously presented financial statements to conform with the 2008 presentation.

2. Dividends

On August 13, 2008, the Company declared a cash dividend on its common stock, payable on November 17, 2008 to stockholders of record as of November 3, 2008, equal to $0.28 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, 2008 and 2007 were 9,432,915 and 9,429,580, respectively. The weighted average outstanding shares for the nine months ended September 30, 2008 and 2007 were 9,430,882 and 9,426,803, 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, 2007.

5. Fair Value Measurements

Effective January 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements, which requires disclosures for those assets and liabilities carried in the balance sheet on a fair value basis. The Financial Accounting Standard Board (FASB) has deferred the effective date of SFAS No. 157 until 2009 for nonfinancial assets and liabilities which are recognized at fair value on a nonrecurring basis. For the Company, this deferral applies to other real estate owned. The Company’s balance sheet contains securities available for sale at fair value.

SFAS No. 157 requires that assets and liabilities carried at fair value also be classified and disclosed according to the process for determining fair value. There are three levels of determining fair value.

Level 1 uses quoted market prices in active markets for identical assets or liabilities.

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Level 2 uses observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3 uses unobservable inputs that are not corroborated by market data.

The following table presents the balances of assets measured at fair value on a recurring basis by level as of September 30, 2008:

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Securities available for sale	$ 323,416,000	$ 68,212,000	$ 255,204,000	$ -

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the securities credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, as well as U.S. Treasury and other U.S. Government sponsored agency securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include U.S. government agencies mortgage-backed securities (including pools and collateralized mortgage obligations), municipal bonds, and corporate debt securities.

Certain assets are measured at fair value on a nonrecurring basis; that is, they are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets carried on the balance sheet (after specific reserves) by caption and by level with the SFAS No. 157 valuation hierarchy as of September 30, 2008:

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Loans	$ 6,324,000	$ -	$ -	$ 6,324,000

Loans in the table above consist of impaired credits held for investment. Impaired loans are valued by management based on collateral values underlying the loans. Management uses original appraised values and adjusts for trends observed in the market.

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The provisions of SFAS No. 159 are effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company has not adopted the fair value option of SFAS No. 159 on any financial instruments thus far in 2008.

6. Investment Securities Impairment

Non-interest income for the quarter and nine months ended September 30, 2008 was negatively impacted by net security losses of $5,487,000 and $6,901,000, respectively. Third quarter 2008 results included additional impairment charges related to the Company's investment in Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) preferred stock and the initial impairment charge for the corporate bond issues of Lehman Brothers Holdings and American General Finance. The carrying values of the preferred stock, the Lehman Brothers Holdings bonds, and American General Finance bonds have been written down to their estimated September 30, 2008 fair market values of $593,000, $497,000 and $260,000, respectively.

Unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of September 30, 2008 and December 31, 2007, are summarized as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2008:						
Securities available for sale:						
U.S. government agencies	$ 12,802,000	$ (104,000)	$ 642,000	$ (23,000)	$ 13,444,000	$ (127,000)
U.S. government mortgage-backed securities	41,233,000	(385,000)	531,000	(11,000)	41,764,000	(396,000)
State and political subsidivisions	50,239,000	(26,000)	3,636,000	(14,000)	53,875,000	(40,000)
Corporate obligations	40,712,000	(2,971,000)	8,503,000	(1,201,000)	49,215,000	(4,172,000)
Equity securities	3,052,000	(405,000)	-	-	3,052,000	(405,000)
	$ 148,038,000	$ (3,891,000)	$ 13,312,000	$ (1,249,000)	$ 161,350,000	$ (5,140,000)

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2007:						
Securities available for sale:						
U.S. government agencies	$ 2,497,127	$ (2,873)	$ 22,807,372	$ (108,334)	$ 25,304,499	$ (111,207)
U.S. government mortgage-backed securities	12,696,160	(71,106)	8,706,270	(144,286)	21,402,430	(215,392)
State and political subsidivisions	14,067,294	(84,174)	26,526,618	(295,222)	40,593,912	(379,396)

Corporate obligations	21,577,269	(786,802)	14,392,174	(243,309)	35,969,443	(1,030,111)
Equity securities	6,336,950	(1,344,550)	-	-	6,336,950	(1,344,550)
	$ 57,174,800	(2,289,505)	$ 72,432,434	$ (791,151)	$ 129,607,234	$ (3,080,656)

7. Impaired Loans and Allowance for Loan Losses

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 payment of principal and 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. The Company will apply its normal loan review procedures to identify loans that should be evaluated for impairment under FAS 114.

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The amount of impairment is included in the allowance for loan losses. The following is a recap of impaired loans at September 30, 2008 and December 31, 2007:

	September 30, 2008	December 31, 2007
Impaired loans without an allowance	$ 3,510,000	$ 3,864,000
Impaired loans with an allowance	3,004,000	1,621,000
Total impaired loans	6,514,000	5,485,000
Allowance for loan losses related to impaired loans	$ 190,000	$ 247,000

Changes in the allowance for loan losses were as follows for the three and nine months ended September 30, 2008 and 2007;

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Balance at beginning of period	$ 6,609,000	$ 6,689,000	$ 5,781,000	$ 6,533,000
Charge-offs	42,000	255,000	212,000	286,000
Recoveries	22,000	11,000	91,000	44,000
Net charge-offs	20,000	244,000	121,000	242,000
Provision (credit) for loan losses	74,000	(264,000)	1,002,000	(111,000)
Balance at end of period	$ 6,663,000	$ 6,181,000	$ 6,662,000	$ 6,180,000

8. Recent Accounting Pronouncements

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivatives Instruments and Hedging Activities – an amendment of FASB Statement No. 133 (FAS 161). FAS 161 changes the disclosure requirements for derivative instruments and hedging activities. It requires enhanced disclosures about how and why an entity uses derivatives, how derivatives and related hedged items are accounted for, and how derivatives and hedged items affect an entity's financial position, performance, and cash flows. The provisions of FAS 161 are effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early adoption encouraged. Because FAS 161 amends only the disclosure requirements for derivative instruments and hedged items, and the Company has limited derivative activity, the adoption of FAS 161 is not expected to materially affect the Company's consolidated financial statements.

Item2. 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.

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 184 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 cash flow 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.

The Company had net income of $4,775,000, or $0.51 per share, for the nine months ended September 30, 2008, compared to net income of $8,287,000, or $0.88 per share, for the nine months ended September 30, 2007. Total equity capital as of September 30, 2008 totaled $104 million or 12.3% of total assets at the end of the quarter.

The Company's earnings for the third quarter were $7,000, down significantly from the $2,939,000, or $0.31 per share earned a year ago. The lower earnings were due to additional impairment charges related to the Company's investment in Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) preferred stock and the initial impairment charge for the corporate bond issues of Lehman Brothers Holdings and American General Finance. The carrying values of the preferred stock, the Lehman Brothers Holdings bonds, and American General Finance bonds have been written down to their estimated September 30, 2008 fair market values of $593,000, $497,000 and $260,000, respectively. These impairment charges contributed to a net securities loss of $5,487,000, or $0.58 per share, for the quarter, equating to an after-tax loss of $3,457,000, or $0.37 per share. Excluding these net securities losses, pre-tax earnings for the quarter totaled $4,300,000 for the three-months ended September 30, 2008, a 9.5% increase over the $3,928,000 earned for the same period in 2007. Management believes that additional impairment charges may be necessary on investment securities in future quarters if financial and economic conditions do not improve as perceived by bond and equity investors.

Positive income items for the quarter included net interest income that was higher than the third quarter of 2007 by $1,353,000, or 23%. The net interest margin for the quarter ended September 30, 2008 was 3.99%, compared to 3.39% for the third quarter of 2007. Also, net loan charge-offs for the quarter totaled $20,000, compared to net charge-offs of $244,000 in the third quarter of 2007.

For the nine month period ending September 30, 2008, net securities losses on the FHLMC and FNMA preferred stock and corporate bonds totaled $6,901,000 compared to net securities gains of $1,444,000 for the nine months ended September 30, 2007. In addition, a higher provision for loan losses of $1,002,000 for the first nine months of 2008 compared to a credit for loan losses of $110,000 for the same period in 2007. Partially offsetting these expense items was an increase in net interest income for the nine month period of $4,089,000 compared to the same nine month period in 2007. The improvement in the net interest income is attributable to lower funding costs as market interest rates paid on deposits have been more favorable for the Company in 2008.

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
- 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.

- On July 16, 2008, the Company's lead bank, First National Bank, entered into an informal Memorandum of Understanding with the Office of the Comptroller of the Currency regarding the Bank's commercial real estate loan portfolio, including actions to be taken with respect to commercial real estate risk management procedures, credit underwriting and administration, appraisal and evaluation process, problem loan management, credit risk ratings recognition and loan review procedures. Since entering into the Memorandum, management has been actively pursuing the corrective actions required by the Memorandum in an effort to address the deficiencies noted in administration of its commercial real estate loan portfolio.

- The Company and affiliate banks have invested in FHLMC and FNMA preferred stock and other corporate bond issues whose financial condition may further deteriorate requiring additional impairment charges. Additional impairment charges may be necessary on investment securities in future periods if financial and economic conditions do not improve as perceived by bond and equity investors.

- Banks have historically earned higher levels of net interest income by investing in longer term loans and securities at higher yields and paying lower deposit expense rates on shorter maturity deposits. However, the difference between the yields on short term and long term investments was very low for much of 2006 and 2007, making it more difficult to manage net interest margins. While this difference in long term and short term yields improved in 2008, if this difference was to narrow or invert during the remainder of 2008, the Company's net interest margin may compress and net interest income may be negatively impacted. Historically, management has been able to position the Company's assets and liabilities to earn a satisfactory net interest margin during periods when the yield curve is flat or inverted by appropriately managing credit spreads on loans and maintaining adequate liquidity to provide flexibility in an effort to hold down funding costs. Management would seek to follow a similar approach in dealing with this challenge for the remainder of 2008.

- Yields on U.S. Treasury securities with maturities of 2 to 5 years decreased on average 53 basis points as of September 30, 2008 compared June 30, 2008. Historically, the Company has improved its net interest margin in a declining interest rate environment. However, increasing market interest rates may present a challenge to the Company if they were to rise significantly in a short period of time. Increases in interest rates may negatively impact the Company's net interest margin if 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 substandard performance in the Company's equity portfolio could lead to a reduction in the historical level of realized security gains, thereby negatively impacting the Company's earnings. The Company invests capital that may be utilized for future expansion in a portfolio of primarily financial stocks with an estimated fair market value of approximately $14 million as of September 30, 2008. The Company focuses on stocks that have historically paid dividends in an effort to lessen the negative effects of a bear market.

- The economic conditions for commercial real estate developers in the Des Moines metropolitan area deteriorated in 2007 and the first nine months of 2008. This deterioration has contributed to the Company's increased level of non-performing assets. During the third quarter of 2008, the Company foreclosed on two real estate properties (other real estate owned) totaling $10.5 million in the Des Moines market. The Company has impaired loans totaling $2.3 million with four Des Moines development companies with specific reserves totaling $72,000. The Company has additional credit relationships with real estate developers in the Des Moines area that presently, have collateral values sufficient to cover loan balances. However, the loans may become impaired in the future if economic conditions do not improve or become worse. As of September 30, 2008, the Company has a limited number of such credits and is actively engaged with the customers to minimize credit risks.

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 8,451 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, 2008		June 30, 2008		Years Ended December 31,			
	3 Months Ended	9 Months Ended	6 Months Ended		2007		2006	
	Company	Company	Company	Industry*	Company	Industry	Company	Industry
Return on assets	0.003%	0.74%	1.09%	0.37%	1.30%	0.86%	1.34%	1.28%
Return on equity	0.03%	5.79%	8.54%	3.58%	9.89%	8.17%	9.99%	12.34%
Net interest margin	3.99%	3.90%	3.85%	3.35%	3.39%	3.29%	3.29%	3.31%
Efficiency ratio	134.58%	67.88%	54.22%	57.93%	53.71%	59.37%	52.27%	56.79%
Capital ratio	12.64%	12.74%	12.78%	7.89%	13.20%	7.98%	13.38%	8.23%

*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 0.003% and 1.39%, respectively, for the three month periods ending September 30, 2008 and 2007. The decline in this ratio in 2008 from the previous year is the result of net security losses.

- 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 return on average equity was 0.03% and 10.69%, respectively for the three month periods ending September 30, 2008 and 2007. Net securities losses in 2008 also caused this profitability ratio to decline compared to the same period in 2007.

Net Interest Margin

The net interest margin for the three months ended September 30, 2008 was 3.99% compared to 3.39% for the three months ended September 30, 2007. 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 has improved primarily as the result of lower interest expense on deposits and other borrowings.

• 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 was 135% and 54% for the three months ended September 30, 2008 and 2007, respectively and increased primarily as the result the net security losses.

• 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 2008:

Second-Quarter Earnings Are 87% Below Year-Earlier Level

The continued downturn in the credit cycle, combined with lingering weakness in financial markets and falling asset values, had a pronounced negative effect on banking industry performance in the second quarter. Insured commercial banks and savings institutions reported net income of $5.0 billion for the second quarter of 2008. This is the second-lowest quarterly total since 1991 and is $31.8 billion (86.5%) less than the industry earned in the second quarter of 2007. Higher loan-loss provisions were the most significant factor in the earnings decline. Loss provisions totaled $50.2 billion, more than four times the $11.4 billion quarterly total of a year ago. Second-quarter provisions absorbed almost one-third (31.9%) of the industry's net operating revenue (net interest income plus total noninterest income), the highest proportion since the third quarter of 1989. A year ago, provisions absorbed only 7.3% of industry revenue. The average return on assets (ROA) in the second quarter was 0.15%, compared to 1.21% a year earlier. Large institutions as a group had more substantial earnings erosion than smaller institutions, but downward earnings pressure was widely evident across the industry. At institutions with assets greater than $1 billion, the average ROA in the second quarter was 0.10%, down from 1.23% a year ago. At institutions with less than $1 billion in assets, the average second quarter ROA was 0.57%, compared to 1.10% in the second quarter of 2007. More than half of all insured institutions (56.4%) reported year-over-year declines in quarterly net income, and almost two out of every three institutions (62.1%) reported lower ROAs. Almost 18% of all insured institutions were unprofitable in the second quarter, compared to only 9.8% in the second quarter of 2007.

Net Charge-Off Rate Rises to Highest Level Since 1991

Loan losses registered a sizable jump in the second quarter, as loss rates on real estate loans increased sharply at many large lenders. Net charge-offs of loans and leases totaled $26.4 billion in the second quarter, almost triple the $8.9 billion that was charged off in the second quarter of 2007. The annualized net charge-off rate in the second quarter was 1.32%, compared to 0.49% a year earlier. This is the highest quarterly charge-off rate for the industry since the fourth quarter of 1991. At institutions with more than $1 billion in assets, the average charge-off rate in the second quarter was 1.46%, more than three times the 0.44% average for institutions with less than $1 billion in assets.

Noncurrent Loan Rate Rises Above 2% for the First Time Since 1993

The amount of loans and leases that were noncurrent (90 days or more past due or in nonaccrual status) rose for a ninth consecutive quarter, increasing by $26.7 billion (19.6%). This is the second-largest quarterly increase in noncurrent loans during the nine-quarter streak, after the $27.0-billion increase in the fourth quarter of 2007 when quarterly net charge-offs were $10 billion lower. At the end of June, the percentage of the industry's total loans and leases that were noncurrent stood at 2.04%, the highest level since the third quarter of 1993.

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, 2008 and 2007:

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.

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,					
	2008			2007		
ASSETS (dollars in thousands)	Average balance	Revenue/ expense	Yield/ rate	Average balance	Revenue/ expense	Yield/ rate
Interest-earning assets						
Loans (1)						
Commercial	$ 85,821	$ 1,230	5.73%	$ 79,248	$ 1,584	8.00%
Agricultural	30,469	520	6.83%	31,873	688	8.63%
Real estate	321,966	5,124	6.37%	325,532	5,414	6.65%
Installment and other	24,422	363	5.95%	21,973	376	6.84%
Total loans (including fees)	$ 462,678	$ 7,237	6.26%	$ 458,626	$ 8,062	7.03%
Investment securities						
Taxable	$ 205,033	$ 2,533	4.94%	$ 202,803	$ 2,458	4.85%
Tax-exempt (2)	133,365	2,056	6.17%	138,165	2,266	6.56%
Total investment securities	$ 338,398	$ 4,589	5.42%	$ 340,968	$ 4,724	5.54%
Interest bearing deposits with banks	$ 5,224	$ 59	4.52%	$ 767	$ 8	4.17%
Federal funds sold	1,687	16	3.79%	56	2	14.29%
Total interest-earning assets	$ 807,987	$ 11,901	5.89%	$ 800,417	$ 12,796	6.39%
Non-interest-earning assets	36,964			42,516		