

AMES NATIONAL CORP
Form 10-Q
November 07, 2014
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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, 2014

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 (I. R. S. Employer
Incorporation or Organization) 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this Chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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	9,310,913
(Class)	

(Shares Outstanding
at October 31, 2014)

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AMES NATIONAL CORPORATION

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	September 30, 2014	December 31, 2013
ASSETS		
Cash and due from banks	\$25,685,197	\$24,270,031
Interest bearing deposits in financial institutions	41,529,118	23,628,117
Securities available-for-sale	568,103,061	580,039,080
Loans receivable, net	615,701,355	564,501,547
Loans held for sale	447,423	295,618
Bank premises and equipment, net	15,984,355	11,892,329
Accrued income receivable	8,589,329	7,437,673
Other real estate owned	10,187,794	8,861,107
Deferred income taxes	1,662,407	5,027,103
Core deposit intangible, net	1,843,857	1,029,564
Goodwill	6,732,216	5,600,749
Other assets	1,695,913	501,242
Total assets	\$1,298,162,025	\$1,233,084,160
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Deposits		
Demand, noninterest bearing	\$175,656,528	\$179,946,472
NOW accounts	294,207,846	299,788,852
Savings and money market	315,650,511	289,307,102
Time, \$100,000 and over	98,705,314	97,077,717
Other time	155,565,574	145,683,035
Total deposits	1,039,785,773	1,011,803,178
Securities sold under agreements to repurchase and federal funds purchased	68,194,012	39,616,644
Federal Home Loan Bank (FHLB) advances	16,986,152	14,540,526
Other borrowings	13,000,000	20,000,000
Dividend payable	1,675,964	1,489,746
Accrued expenses and other liabilities	4,550,116	3,527,882
Total liabilities	1,144,192,017	1,090,977,976

STOCKHOLDERS' EQUITY

Common stock, \$2 par value, authorized 18,000,000 shares; issued 9,432,915 shares as of September 30, 2014 and December 31, 2013; outstanding 9,310,913 shares as of September 30, 2014 and December 31, 2013	18,865,830	18,865,830
Additional paid-in capital	22,651,222	22,651,222
Retained earnings	109,239,104	102,154,498
Accumulated other comprehensive income - net unrealized gain on securities available-for-sale	5,230,350	451,132
Treasury stock, at cost; 122,002 shares at September 30, 2014 and December 31, 2013	(2,016,498)	(2,016,498)
Total stockholders' equity	153,970,008	142,106,184
Total liabilities and stockholders' equity	\$1,298,162,025	\$1,233,084,160

See Notes to Consolidated Financial Statements.

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AMES NATIONAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest income:				
Loans, including fees	\$6,722,179	\$6,569,005	\$19,708,190	\$18,874,279
Securities:				
Taxable	1,792,258	1,357,658	5,407,157	4,137,431
Tax-exempt	1,538,531	1,737,687	4,857,733	5,212,498
Interest bearing deposits and federal funds sold	67,183	86,126	213,259	304,172
Total interest income	10,120,151	9,750,476	30,186,339	28,528,380
Interest expense:				
Deposits	803,098	924,219	2,557,799	2,919,660
Other borrowed funds	299,434	315,116	897,781	905,966
Total interest expense	1,102,532	1,239,335	3,455,580	3,825,626
Net interest income	9,017,619	8,511,141	26,730,759	24,702,754
Provision for loan losses	55,145	92,388	130,020	165,962
Net interest income after provision for loan losses	8,962,474	8,418,753	26,600,739	24,536,792
Noninterest income:				
Wealth management income	686,955	532,709	2,108,150	1,631,478
Service fees	426,588	402,062	1,194,862	1,179,889
Securities gains, net	79,501	204,738	214,582	637,979
Gain on sale of loans held for sale	224,554	268,658	473,733	969,578
Merchant and card fees	281,766	271,485	831,405	884,583
Gain on the sale of premises and equipment, net	-	-	1,242,209	-
Other noninterest income	129,326	140,081	443,505	448,214
Total noninterest income	1,828,690	1,819,733	6,508,446	5,751,721
Noninterest expense:				
Salaries and employee benefits	3,513,375	3,288,760	10,235,563	9,736,156
Data processing	656,715	581,301	1,823,635	1,781,152
Occupancy expenses, net	366,258	358,739	1,185,066	1,103,920

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FDIC insurance assessments	164,535	173,878	490,231	506,629
Professional fees	332,988	313,174	963,876	853,202
Business development	303,026	255,899	726,503	649,283
Other real estate owned, net	(19,908)	(14,436)	(198)	653,302
Core deposit intangible amortization	76,959	65,751	203,707	207,949
Other operating expenses, net	272,474	207,437	776,248	696,195
Total noninterest expense	5,666,422	5,230,503	16,404,631	16,187,788
Income before income taxes	5,124,742	5,007,983	16,704,554	14,100,725
Provision for income taxes	1,393,256	1,295,916	4,592,054	3,524,028
Net income	\$3,731,486	\$3,712,067	\$12,112,500	\$10,576,697
Basic and diluted earnings per share	\$0.40	\$0.40	\$1.30	\$1.14
Dividends declared per share	\$0.18	\$0.16	\$0.54	\$0.48

See Notes to Consolidated Financial Statements.

Table Of Contents**AMES NATIONAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME***(unaudited)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	\$3,731,486	\$3,712,067	\$12,112,500	\$10,576,697
Other comprehensive income (loss), before tax:				
Unrealized gains (losses) on securities before tax:				
Unrealized holding gains (losses) arising during the period	(572,017)	4,563,574	7,800,643	(14,424,859)
Less: reclassification adjustment for gains realized in net income	79,501	204,738	214,582	637,979
Other comprehensive income (loss) before tax	(651,518)	4,358,836	7,586,061	(15,062,838)
Tax effect related to other comprehensive income (loss)	241,062	(1,612,769)	(2,806,843)	5,573,250
Other comprehensive income (loss), net of tax	(410,456)	2,746,067	4,779,218	(9,489,588)
Comprehensive income	\$3,321,030	\$6,458,134	\$16,891,718	\$1,087,109

See Notes to Consolidated Financial Statements.

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AMES NATIONAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(unaudited)

Nine Months Ended September 30, 2014 and 2013

	Common Stock	Additional Paid- in-Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net of Taxes	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2012	\$ 18,865,830	\$ 22,651,222	\$ 94,159,839	\$ 11,075,342	\$(2,016,498)	\$ 144,735,735
Net income	-	-	10,576,697	-	-	10,576,697
Other comprehensive (loss)	-	-	-	(9,489,588)	-	(9,489,588)
Cash dividends declared, \$0.48 per share	-	-	(4,469,239)	-	-	(4,469,239)
Balance, September 30, 2013	\$ 18,865,830	\$ 22,651,222	\$ 100,267,297	\$ 1,585,754	\$(2,016,498)	\$ 141,353,605
Balance, December 31, 2013	\$ 18,865,830	\$ 22,651,222	\$ 102,154,498	\$ 451,132	\$(2,016,498)	\$ 142,106,184
Net income	-	-	12,112,500	-	-	12,112,500
Other comprehensive income	-	-	-	4,779,218	-	4,779,218
Cash dividends declared, \$0.54 per share	-	-	(5,027,894)	-	-	(5,027,894)
Balance, September 30, 2014	\$ 18,865,830	\$ 22,651,222	\$ 109,239,104	\$ 5,230,350	\$(2,016,498)	\$ 153,970,008

See Notes to Consolidated Financial Statements.

Table Of Contents**AMES NATIONAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS***(unaudited)***Nine Months Ended September 30, 2014 and 2013**

	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 12,112,500	\$ 10,576,697
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	130,020	165,962
Provision for off-balance sheet commitments	53,000	25,700
Amortization, net, securities available-for-sale	3,133,065	4,881,915
Amortization of core deposit intangible asset	203,707	207,949
Depreciation	605,100	588,729
Debit (credit) for deferred income taxes	557,853	(162,516)
Securities gains, net	(214,582)	(637,979)
(Gain) on sale of premises and equipment, net	(1,242,209)	-
Impairment of other real estate owned	-	670,000
(Gain) on sale of other real estate owned, net	(7,175)	(32,601)
Change in assets and liabilities:		
(Increase) decrease in loans held for sale	(151,805)	402,426
(Increase) in accrued income receivable	(921,324)	(917,171)
(Increase) decrease in other assets	(452,695)	1,893,136
Increase in accrued expenses and other liabilities	115,795	330,819
Net cash provided by operating activities	13,921,250	17,993,066
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of securities available-for-sale	(61,818,547)	(133,272,394)
Proceeds from sale of securities available-for-sale	31,688,263	28,314,668
Proceeds from maturities and calls of securities available-for-sale	57,120,089	90,110,257
Net (increase) decrease in interest bearing deposits in financial institutions	(12,182,001)	10,383,741
Net (increase) in loans	(6,705,707)	(18,638,285)
Net proceeds from the sale of other real estate owned	78,990	493,360
Net proceeds from the sale of bank premises and equipment	1,746,444	-
Purchase of bank premises and equipment, net	(1,329,925)	(419,973)
Cash acquired, net of cash paid, for acquired bank offices	16,428,981	-
Other	(19,673)	-
Net cash provided by (used in) investing activities	25,006,914	(23,028,626)

CASH FLOWS FROM FINANCING ACTIVITIES

(Decrease) in deposits	(53,879,019)	(27,567,314)
Increase in securities sold under agreements to repurchase and federal funds purchased	25,762,071	4,884,943
Proceeds from FHLB borrowings	-	2,000,000
Payments on FHLB borrowings and other borrowings	(7,054,374)	(2,052,671)
Proceeds from short-term FHLB borrowings, net	2,500,000	23,000,000
Dividends paid	(4,841,676)	(4,376,120)
Net cash used in financing activities	(37,512,998)	(4,111,162)

Net increase (decrease) in cash and due from banks	1,415,166	(9,146,722)
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CASH AND DUE FROM BANKS

Beginning	24,270,031	34,805,371
Ending	\$25,685,197	\$25,658,649

Table Of Contents**AMES NATIONAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)***(unaudited)***Nine Months Ended September 30, 2014 and 2013**

	2014	2013
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash payments for:		
Interest	\$3,602,255	\$4,169,666
Income taxes	4,147,836	3,580,854
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES		
Transfer of loans receivable to other real estate owned	\$111,109	\$213,749
Business Combination:		
Fair value of interest bearing deposits in financial institutions acquired	\$5,719,000	\$-
Fair value of securities available-for-sale acquired	10,602,454	-
Fair value of loans receivable acquired	44,620,021	-
Fair value of bank premises and equipment acquired	3,864,900	-
Fair value of accrued interest receivable acquired	230,332	-
Fair value of other real estate owned acquired	1,267,720	-
Fair value of other tangible assets acquired	748,511	-
Goodwill	1,131,467	-
Core deposit intangible	1,018,000	-
Deposits assumed	81,962,650	-
Securities sold under repurchase agreements to repurchase assumed	2,815,297	-
Other liabilities assumed	853,439	-

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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 months ended September 30, 2014 and 2013 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 accounting principles generally accepted in the United States of America 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 Annual Report on Form 10-K for the year ended December 31, 2013 (the "Annual Report"). The consolidated 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.

Goodwill: Goodwill represents the excess of cost over the fair value of net assets acquired. Goodwill resulting from acquisitions is not amortized, but is tested for impairment annually or whenever events change and circumstances indicate that it is more likely than not that an impairment loss has occurred. Goodwill is tested for impairment using a two-step process that begins with an estimation of the fair value of a reporting unit. The second step, if necessary, measures the amount of impairment, if any.

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions and selecting an appropriate control premium. At September 30, 2014, Company management has performed a goodwill impairment analysis and determined goodwill was not impaired.

New Accounting Pronouncements: In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-04, Receivables—Troubled Debt Restructuring by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure. The update clarifies when an in substance foreclosure occurs, that is, when a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan. This is the point when

the consumer mortgage loan should be derecognized and the real property recognized. For public companies, this update will be effective for interim and annual periods beginning after December 31, 2014 and early adoption is permitted. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures." The new guidance aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The amendments in the ASU also require expanded disclosures about the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for public companies for the first interim or annual period beginning after December 15, 2014. The adoption of this ASU may result in additional disclosures but is not expected to impact significantly the Company's consolidated financial statements.

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2. Branch Acquisition

On August 29, 2014, First National Bank (FNB) completed the purchase of three bank branches of First Bank located in West Des Moines and Johnston, Iowa. (the "Acquisition") The Acquisition was consistent with the Bank's strategy to strengthen and expand its Iowa market share. The acquired assets and liabilities were recorded at fair value at the date of acquisition and were reflected in the September 30, 2014 financial statements as such. These branches were purchased for cash consideration of \$4.1 million. As a result of the acquisition, the Company recorded a core deposit intangible asset of \$1,018,000 and goodwill of \$1,131,000. The results of operations for this acquisition have been included since the transaction date of August 29, 2014. The fair value of credit deteriorated purchased loans related to this Acquisition is \$1,507,000. These purchase loans are included in the impaired loan category in the financial statements. Non-routine expenses associated with this transaction were approximately \$123,000 for the nine months ended September 30, 2014.

The following table summarizes the fair value of the total consideration transferred as a part of the Acquisition as well as the fair value of identifiable assets acquired and liabilities assumed as of the effective date of the transaction.

Cash consideration transferred	\$4,147,680
Recognized amounts of identifiable assets acquired and liabilities assumed:	
Cash and Due from Banks	\$20,576,661
Interest bearing deposits in financial institutions	5,719,000
Securities available-for-sale	10,602,454
Loans receivable	44,620,021
Accrued interest receivable	230,332
Bank premises and equipment	3,864,900
Other real estate owned	1,267,720
Core deposit intangible asset	1,018,000
Other assets	748,511
Deposits	(81,962,650)
Securities sold under agreements to repurchase	(2,815,297)
Accrued interest payable and other liabilities	(853,439)
Total identifiable net assets	\$3,016,213
Goodwill	\$1,131,467

On August 29, 2014, the contractual balance of loans receivable acquired was \$45,584,000 and the contractual balance of the deposits assumed was \$81,841,000. Loans receivable acquired include commercial real estate, 1-4 family real estate, commercial operating and consumer loans.

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The acquired loans at contractual values as of August 29, 2014 were determined to be risk rated as follows:

Pass	\$29,840,000
Watch	6,659,000
Special Mention	1,478,000
Substandard	5,460,000
Deteriorated credit	2,147,000

Total loans acquired at book value \$45,584,000

Loans acquired as deteriorated credit loans will be included with impaired loans.

The core deposit intangible asset is amortized to expense on a declining basis over a period of nine years. The loan market valuation is accreted to income on a declining basis over a six year period. The time deposits market valuation is amortized to expense on a declining basis over a two year period.

The excess cash in the transaction has been utilized through reductions in federal funds purchased and other borrowings at FNB. Going forward any excess cash will be used in the form of investment and or loan growth.

3.Dividends

On August 13, 2014, the Company declared a cash dividend on its common stock, payable on November 14, 2014 to stockholders of record as of October 31, 2014, equal to \$0.18 per share.

4.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 and nine months ended September 30, 2014 and 2013 were 9,310,913. The Company had no potentially dilutive securities outstanding during the periods presented.

5.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, 2013.

6. Fair Value Measurements

Assets and liabilities carried at fair value are required to be classified and disclosed according to the process for determining fair value. There are three levels of determining fair value.

Level 1: Inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2: Inputs to the valuation methodology include: quoted prices for similar assets or liabilities in active markets; quoted process for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatility, prepayment speeds, credit risk); or inputs derived principally from or can be corroborated by observable market data by correlation or other means.

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Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement. Level 3 assets and liabilities include financial instruments whose value is determined using discounted cash flow methodologies, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

The following table presents the balances of assets measured at fair value on a recurring basis by level as of September 30, 2014 and December 31, 2013. *(in thousands)*

Description	Total	Level 1	Level 2	Level 3
2014				
U.S. government treasuries	\$1,437	\$1,437	\$-	\$ -
U.S. government agencies	93,916	-	93,916	-
U.S. government mortgage-backed securities	133,156	-	133,156	-
State and political subdivisions	288,030	-	288,030	-
Corporate bonds	47,783	-	47,783	-
Equity securities, financial industry common stock	769	769	-	-
Equity securities, other	3,012	-	3,012	-
	\$568,103	\$2,206	\$565,897	\$ -
2013				
U.S. government agencies	\$61,178	\$-	\$61,178	\$ -
U.S. government mortgage-backed securities	155,142	-	155,142	-
State and political subdivisions	315,224	-	315,224	-
Corporate bonds	44,752	-	44,752	-
Equity securities, financial industry common stock	841	841	-	-
Equity securities, other	2,902	-	2,902	-
	\$580,039	\$841	\$579,198	\$ -

Level 1 securities include equity securities traded on an active exchange, such as the New York Stock Exchange, as well as U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets. U.S. government mortgage-backed securities, state and political subdivisions, most corporate bonds and other equity securities are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the security's terms and conditions, among other things.

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The Company's policy is to recognize transfers between Levels at the end of each reporting period, if applicable. There were no transfers between Levels of the fair value hierarchy during the nine months ended September 30, 2014.

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 valuation hierarchy as of September 30, 2014 and December 31, 2013. *(in thousands)*

Description	Total	Level 1	Level 2	Level 3
2014				
Loans receivable	\$297	\$ -	\$ -	\$297
Other real estate owned	10,188	-	-	10,188
Total	\$10,485	\$ -	\$ -	\$10,485
2013				
Loans receivable	\$648	\$ -	\$ -	\$648
Other real estate owned	8,861	-	-	8,861
Total	\$9,509	\$ -	\$ -	\$9,509

Loans Receivable: Loans in the tables above consist of impaired credits held for investment. In accordance with the loan impairment guidance, impairment was measured based on the fair value of collateral less estimated selling costs for collateral dependent loans. Fair value for impaired loans is based upon appraised values of collateral adjusted for trends observed in the market. A valuation allowance was recorded for the excess of the loan's recorded investment over the amounts determined by the collateral value method. This valuation is a component of the allowance for loan losses. The Company considers these fair value measurements as level 3.

Other Real Estate Owned: Other real estate owned in the table above consists of real estate obtained through foreclosure. Other real estate owned is recorded at fair value less estimated selling costs, at the date of transfer. Subsequent to the transfer, other real estate owned is carried at the lower of cost or fair value, less estimated selling costs. The carrying value of other real estate owned is not re-measured to fair value on a recurring basis but is subject to fair value adjustments when the carrying value exceeds the fair value less estimated selling costs. Management uses appraised values and adjusts for trends observed in the market and for disposition costs in determining the value of other real estate owned. A valuation allowance was recorded for the excess of the asset's recorded investment over the amount determined by the fair value, less estimated selling costs. This valuation allowance is a component of the

allowance for other real estate owned. The valuation allowance was \$4,644,000 as of September 30, 2014 and December 31, 2013. The Company considers these fair values level 3.

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The significant inputs used in the fair value measurements for Level 3 assets measured at fair value on a nonrecurring basis as of September 30, 2014 and December 31, 2013 are as follows: *(in thousands)*

	2014 Fair Value	Valuation Techniques	Range of Unobservable Inputs	Range (Average)
Impaired Loans	\$ 274	Evaluation of collateral	Estimation of value	NM*
Other real estate owned	\$ 10,188	Appraisal	Appraisal adjustment	6%-10% (8%)
	2013 Fair Value	Valuation Techniques	Range of Unobservable Inputs	Range (Average)
Impaired Loans	\$ 648	Evaluation of collateral	Estimation of value	NM*
Other real estate owned	\$ 8,861	Appraisal	Appraisal adjustment	6%-10% (8%)

* Not Meaningful. Evaluations of the underlying assets are completed for each impaired loan with a specific reserve. The types of collateral vary widely and could include accounts receivables, inventory, a variety of equipment and real estate. Collateral evaluations are reviewed and discounted as appropriate based on knowledge of the specific type of collateral. In the case of real estate, an independent appraisal may be obtained. Types of discounts considered included aging of receivables, condition of the collateral, potential market for the collateral and estimated disposal costs. These discounts will vary from loan to loan, thus providing a range would not be meaningful.

Accounting principles generally accepted in the United State of America (GAAP) requires disclosure of the fair value of financial assets and financial liabilities, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis. The methodologies for estimating the fair value of financial assets and financial liabilities that are measured at fair value on a recurring or nonrecurring basis are discussed above. The methodologies for other financial assets and financial liabilities are discussed below.

Fair value of financial instruments:

Disclosure of fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the consolidated balance sheets. In cases in which quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimate of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases could not be realized in immediate settlement of the instruments. Certain financial instruments with a fair value that is not practicable to estimate and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not necessarily represent the underlying value of the Company.

The following disclosures represent financial instruments in which the ending balances at September 30, 2014 and December 31, 2013 are not carried at fair value in their entirety on the consolidated balance sheets.

Cash and due from banks and interest bearing deposits in financial institutions: The recorded amount of these assets approximates fair value.

Securities available-for-sale: Fair value measurement for Level 1 securities is based upon quoted prices. Fair value measurement for Level 2 securities are based upon quoted prices, if available. If quoted prices are not available, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the security's terms and conditions, among other things. Level 1 securities include equity securities traded on an active exchange, such as the New York Stock Exchange, as well as U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets. U.S government mortgage-backed securities, state and political subdivisions, some corporate bonds and other equity securities are reported at fair value utilizing Level 2 inputs.

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Loans held for sale: The fair value of loans held for sale is based on prevailing market prices.

Loans receivable: The fair value of loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates, which reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the historical experience, with repayments for each loan classification modified, as required, by an estimate of the effect of current economic and lending conditions. The effect of nonperforming loans is considered in assessing the credit risk inherent in the fair value estimate.

Deposit liabilities: Fair values of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings and NOW accounts, and money market accounts, are equal to the amount payable on demand as of the respective balance sheet date. Fair values of certificates of deposit are based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market.

Securities sold under agreements to repurchase and federal funds purchased: The carrying amounts of securities sold under agreements to repurchase and federal funds purchased approximate fair value because of the generally short-term nature of the instruments.

FHLB advances and other borrowings: Fair values of FHLB advances and other borrowings are estimated using discounted cash flow analysis based on interest rates currently being offered with similar terms.

Accrued income receivable and accrued interest payable: The carrying amounts of accrued income receivable and accrued interest payable approximate fair value.

Commitments to extend credit and standby letters of credit: The fair values of commitments to extend credit and standby letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and credit worthiness of the counterparties. The carry value and fair value of the commitments to extend credit and standby letters of credit are not considered significant.

Limitations: Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current

economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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The estimated fair values of the Company's financial instruments as described above as of September 30, 2014 and December 31, 2013 are as follows: *(in thousands)*

	Fair Value Hierarchy Level	2014		2013	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:					
Cash and due from banks	Level 1	\$25,685	\$25,685	\$24,270	\$24,270
Interest bearing deposits	Level 1	41,529	41,529	23,628	23,628
Securities available-for-sale	See previous table	568,103	568,103	580,039	580,039
Loans receivable, net	Level 2	615,701	617,261	564,502	562,073
Loans held for sale	Level 2	447	447	296	296
Accrued income receivable	Level 1	8,589	8,589	7,438	7,438
Financial liabilities:					
Deposits	Level 2	\$1,039,786	\$1,042,096	\$1,011,803	\$1,014,150
Securities sold under agreements to repurchase	Level 1	68,194	68,194	39,617	39,617
FHLB advances	Level 2	16,986	17,877	14,541	15,441
Other borrowings	Level 2	13,000	14,451	20,000	22,033
Accrued interest payable	Level 1	549	549	594	594

The methodologies used to determine fair value as of September 30, 2014 did not change from the methodologies described in the December 31, 2013 Annual Financial Statements.

7. Debt and Equity Securities

The amortized cost of securities available-for-sale and their fair values as of September 30, 2014 and December 31, 2013 are summarized below: *(in thousands)*

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2014:				
U.S. government treasuries	\$ 1,428	\$ 9	\$ -	\$1,437
U.S. government agencies	93,654	1,013	(751)	93,916

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U.S. government mortgage-backed securities	130,458	3,037	(339)	133,156
State and political subdivisions	282,371	6,216	(557)	288,030
Corporate bonds	48,248	608	(1,073)	47,783
Equity securities, financial industry common stock	630	139	-	769
Equity securities, other	3,012	-	-	3,012
	\$ 559,801	\$ 11,022	\$ (2,720)	\$ 568,103

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	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2013:				
U.S. government agencies	\$ 61,569	\$ 1,117	\$ (1,508)	\$ 61,178
U.S. government mortgage-backed securities	153,857	2,847	(1,562)	155,142
State and political subdivisions	314,177	5,056	(4,009)	315,224
Corporate bonds	46,187	756	(2,192)	44,751
Equity securities, financial industry common stock	630	211	-	841
Equity securities, other	2,903	-	-	2,903
	\$ 579,323	\$ 9,987	\$ (9,271)	\$ 580,039

The proceeds, gains and losses from securities available-for-sale are summarized as follows: *(in thousands)*

	Three Months Ended September 30, 2014 2013		Nine Months Ended September 30, 2014 2013	
Proceeds from sales of securities available-for-sale	\$28,209	\$12,697	\$31,688	\$28,315
Gross realized gains on securities available-for-sale	232	261	367	696
Gross realized losses on securities available-for-sale	(152)	56	(152)	58
Tax provision applicable to net realized gains on securities available-for-sale	30	76	80	238

Unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are summarized as of September 30, 2014 and December 31, 2013 are as follows: *(in thousands)*

	Less than 12 Months Fair Value		12 Months or More Fair Value		Total Fair Value		Unrealized Losses	
	Unrealized Losses		Unrealized Losses		Unrealized Losses		Unrealized Losses	
2014:								
Securities available-for-sale:								
U.S. government agencies	\$22,327	\$ (127)	\$17,366	\$ (624)	\$39,693	\$ (751)		
U.S. government mortgage-backed securities	5,278	(20)	29,104	(319)	34,382	(339)		
State and political subdivisions	18,715	(91)	36,056	(466)	54,771	(557)		
Corporate bonds	7,043	(75)	23,669	(998)	30,712	(1,073)		

\$53,363 \$ (313) \$106,195 \$ (2,407) \$159,558 \$ (2,720)

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	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
2013:						
Securities available-for-sale:						
U.S. government agencies	\$31,806	\$ (1,508)	\$-	\$ -	\$31,806	\$ (1,508)
U.S. government mortgage-backed securities	71,327	(1,479)	2,772	(83)	74,099	(1,562)
State and political subdivisions	99,974	(3,029)	15,438	(980)	115,412	(4,009)
Corporate bonds	21,382	(1,151)	8,798	(1,041)	30,180	(2,192)
	\$224,489	\$ (7,167)	\$27,008	\$ (2,104)	\$251,497	\$ (9,271)

Gross unrealized losses on debt securities totaled \$2,720,000 as of September 30, 2014. These unrealized losses are generally due to changes in interest rates or general market conditions. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and industry analysts' reports. Management concluded that the gross unrealized losses on debt securities were temporary. Due to potential changes in conditions, it is at least reasonably possible that changes in fair values and management's assessments will occur in the near term and that such changes could materially affect the amounts reported in the Company's financial statements.

8.Loan Receivable and Credit Disclosures

Activity in the allowance for loan losses, on a disaggregated basis, for the three and nine months ended September 30, 2014 and 2013 is as follows: *(in thousands)*

	Three Months Ended September 30, 2014							
	1-4 Family Residential		Commercial	Agricultural	Commercial Agricultural		Consumer and Other	Total
	Real Estate	Real Estate	Real Estate	Real Estate	Commercial	Agricultural		
Balance, June 30 2014	\$514	\$ 1,503	\$ 3,144	\$ 694	\$ 1,396	\$ 1,106	\$ 160	\$8,517
Provision (credit) for loan losses	(3)	97	12	(2)	(75)	5	21	55
Recoveries of loans charged-off	-	2	15	-	1	-	4	22
Loans charged-off	-	(35)	-	-	(17)	-	(12)	(64)
Balance, September 30 2014	\$511	\$ 1,567	\$ 3,171	\$ 692	\$ 1,305	\$ 1,111	\$ 173	\$8,530

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Nine Months Ended September 30 2014

	1-4 Family Construction Real Estate	Residential Real Estate	Commercial Real Estate	Agricultural Real Estate	Commercial	Agricultural	Consumer and Other	Total
Balance, December 31, 2013	\$ 392	\$ 1,523	\$ 3,230	\$ 686	\$ 1,435	\$ 1,165	\$ 141	\$ 8,572
Provision (credit) for loan losses	119	178	(74)	6	(130)	(54)	85	130
Recoveries of loans charged-off	-	9	15	-	17	-	15	56
Loans charged-off	-	(143)	-	-	(17)	-	(68)	(228)
Balance, September 30, 2014	\$ 511	\$ 1,567	\$ 3,171	\$ 692	\$ 1,305	\$ 1,111	\$ 173	\$ 8,530

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	Three Months Ended September 30, 2013							
	1-4 Family							
	Construction Real Estate	Residential Real Estate	Commercial Real Estate	Agricultural Real Estate	Commercial	Agricultural	Consumer and Other	Total
Balance, June 30, 2013	\$ 332	\$ 1,456	\$ 3,002	\$ 591	\$ 1,343	\$ 921	\$ 174	\$ 7,819
Provision (credit) for loan losses	(111)	40	162	21	(78)	68	(10)	92
Recoveries of loans charged-off	-	2	17	-	1	-	4	24
Loans charged-off	-	(18)	-	-	-	-	(14)	(32)
Balance, September 30, 2013	\$ 221	\$ 1,480	\$ 3,181	\$ 612	\$ 1,266	\$ 989	\$ 154	\$ 7,903

	Nine Months Ended September 30, 2013							
	1-4 Family							
	Construction Real Estate	Residential Real Estate	Commercial Real Estate	Agricultural Real Estate	Commercial	Agricultural	Consumer and Other	Total
Balance, December 31, 2012	\$ 375	\$ 1,433	\$ 2,859	\$ 523	\$ 1,461	\$ 945	\$ 177	\$ 7,773
Provision (credit) for loan losses	(154)	88	305	89	(198)	44	(8)	166
Recoveries of loans charged-off	-	40	17	-	3	-	12	72
Loans charged-off	-	(81)	-	-	-	-	(27)	(108)
Balance, September 30, 2013	\$ 221	\$ 1,480	\$ 3,181	\$ 612	\$ 1,266	\$ 989	\$ 154	\$ 7,903

Allowance for loan losses disaggregated on the basis of impairment analysis method as of September 30, 2014 and December 31, 2013 is as follows: *(in thousands)*

2014

	1-4 Family							
	Construction Residential Commercial Agricultural							
	Real Estate	Real Estate	Real Estate	Real Estate	Commercial	Agricultural	Consumer and Other	Total
Individually evaluated for impairment	\$ -	\$ 47	\$ 34	\$ -	\$ 190	\$ -	\$ 3	\$ 274
	511	1,520	3,137	692	1,115	1,111	170	8,256

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Collectively evaluated for
impairment

Balance September 30, 2014	\$ 511	\$ 1,567	\$ 3,171	\$ 692	\$ 1,305	\$ 1,111	\$ 173	\$8,530
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2013

	Construction Real Estate	1-4 Family Residential Real Estate	Commercial Real Estate	Agricultural Real Estate	Commercial Agricultural	Agricultural and Other	Consumer and Other	Total
Individually evaluated for impairment	\$ -	\$ 122	\$ 20	\$ -	\$ 330	\$ 5	\$ -	\$477
Collectively evaluated for impairment	392	1,401	3,210	686	1,105	1,160	141	8,095
Balance December 31, 2013	\$ 392	\$ 1,523	\$ 3,230	\$ 686	\$ 1,435	\$ 1,165	\$ 141	\$8,572

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Loans receivable disaggregated on the basis of impairment analysis method as of September 30, 2014 and December 31, 2013 is as follows (*in thousands*):

	2014							Total
	Construction Real Estate	1-4 Family Residential Real Estate	Commercial Real Estate	Agricultural Real Estate	Commercial	Agricultural	Consumer and Other	
Individually evaluated for impairment	\$ 412	\$ 503	\$ 864	\$ -	\$ 724	\$ 19	\$ 11	\$ 2,533
Collectively evaluated for impairment	32,974	134,784	222,248	55,297	88,215	73,575	14,670	621,763
Balance September 30, 2014	\$ 33,386	\$ 135,287	\$ 223,112	\$ 55,297	\$ 88,939	\$ 73,594	\$ 14,681	\$ 624,296
	2013							
	Construction Real Estate	1-4 Family Residential Real Estate	Commercial Real Estate	Agricultural Real Estate	Commercial	Agricultural	Consumer and Other	Total
Individually evaluated for impairment	\$ 510	\$ 784	\$ 526	\$ -	\$ 816	\$ 24	\$ 61	\$ 2,721
Collectively evaluated for impairment	23,418	107,506	205,585	53,834	86,007	81,302	12,734	570,386
Balance December 31, 2013	\$ 23,928	\$ 108,290	\$ 206,111	\$ 53,834	\$ 86,823	\$ 81,326	\$ 12,795	\$ 573,107

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. The credit deteriorated loans acquired as a part of the Acquisition have been included in the following information. 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.

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The following is a recap of impaired loans, on a disaggregated basis, at September 30, 2014 and December 31, 2013:
(in thousands)

	2014			2013		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no specific reserve recorded:						
Real estate - construction	\$412	\$ 412	\$ -	\$510	\$ 510	\$ -
Real estate - 1 to 4 family residential	304	304	-	483	483	-
Real estate - commercial	705	705	-	480	480	-
Real estate - agricultural	-	-	-	-	-	-
Commercial	514	514	-	43	43	-
Agricultural	19	19	-	19	19	-
Consumer and other	8	8	-	61	61	-
Total loans with no specific reserve:	1,962	1,962	-	1,596	1,596	-
With an allowance recorded:						
Real estate - construction	-	-	-	-	-	-
Real estate - 1 to 4 family residential	199	214	47	301	301	122
Real estate - commercial	159	159	34	46	46	20
Real estate - agricultural	-	-	-	-	-	-
Commercial	210	210	190	773	773	330
Agricultural	-	-	-	5	5	5
Consumer and other	3	3	3	-	-	-
Total loans with specific reserve:	571	586	274	1,125	1,125	477
Total						
Real estate - construction	412	412	-	510	510	-
Real estate - 1 to 4 family residential	503	518	47	784	784	122
Real estate - commercial	864	864	34	526	526	20
Real estate - agricultural	-	-	-	-	-	-
Commercial	724	724	190	816	816	330
Agricultural	19	19	-	24	24	5
Consumer and other	11	11	3	61	61	-
	\$2,533	\$ 2,548	\$ 274	\$2,721	\$ 2,721	\$ 477

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The following is a recap of the average recorded investment and interest income recognized on impaired loans for the three and nine months ended September 30, 2014 and 2013: *(in thousands)*

	Three Months Ended September 30, 2014		September 30, 2013	
	Average Interest Recorded Investment	Interest Recognized	Average Interest Recorded Investment	Interest Recognized
With no specific reserve recorded:				
Real estate - construction	\$419	\$ -	\$805	\$ -
Real estate - 1 to 4 family residential	185	7	478	8
Real estate - commercial	374	-	1,382	207
Real estate - agricultural	-	-	-	-
Commercial	274	-	41	12
Agricultural	19	-	-	-
Consumer and other	8	-	7	-
Total loans with no specific reserve:	1,279	7	2,713	227
With an allowance recorded:				
Real estate - construction	-	-	195	93
Real estate - 1 to 4 family residential	209	-	334	-
Real estate - commercial	160	-	46	-
Real estate - agricultural	-	-	-	-
Commercial	274	-	813	-
Agricultural	2	-	5	-
Consumer and other	4	-	-	-
Total loans with specific reserve:	649	-	1,393	93
Total				
Real estate - construction	419	-	1,000	93
Real estate - 1 to 4 family residential	394	7	812	8
Real estate - commercial	534	-	1,428	207
Real estate - agricultural	-	-	-	-
Commercial	548	-	854	12
Agricultural	21	-	5	-
Consumer and other	12	-	7	-
	\$1,928	\$ 7	\$4,106	\$ 320

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	Nine Months Ended September 30,			
	2014		2013	
	Average Interest	Average Interest	Average Interest	Average Interest
	Recorded	Recorded	Recorded	Recorded
	Investment	Investment	Investment	Investment
	Recognized	Recognized	Recognized	Recognized
With no specific reserve recorded:				
Real estate - construction	\$461	\$ -	\$919	\$ -
Real estate - 1 to 4 family residential	230	12	569	8
Real estate - commercial	318	206	1,189	209
Real estate - agricultural	-	-	-	-
Commercial	158	-	58	12
Agricultural	19	-	-	-
Consumer and other	23	-	5	-
Total loans with no specific reserve:	1,209	218	2,740	229
With an allowance recorded:				
Real estate - construction	-	-	313	93
Real estate - 1 to 4 family residential	279	-	420	-
Real estate - commercial	103	-	1,147	-
Real estate - agricultural	-	-	-	-
Commercial	519	70	745	-
Agricultural	3	-	6	-
Consumer and other	2	-	-	-
Total loans with specific reserve:	906	70	2,631	93
Total				
Real estate - construction	461	-	1,232	93
Real estate - 1 to 4 family residential	509	12	989	8
Real estate - commercial	421	206	2,336	209
Real estate - agricultural	-	-	-	-
Commercial	677	70	803	12
Agricultural	22	-	6	-
Consumer and other	25	-	5	-
	\$2,115	\$ 288	\$5,371	\$ 322

The interest foregone on nonaccrual loans for the three months ended September 30, 2014 and 2013 was approximately \$34,000 and \$73,000, respectively. The interest foregone on nonaccrual loans for the nine months ended September 30, 2014 and 2013 was approximately \$95,000 and \$239,000, respectively.

The Company had loans meeting the definition of a troubled debt restructuring (TDR) of \$723,000 as of September 30, 2014, of which all were included in impaired loans and nonaccrual loans. The Company had TDRs of \$1,424,000 as of December 31, 2013, all of which were included in impaired loans, \$1,237,000 was included as nonaccrual loans and \$187,000 was on accrual status.

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The following table sets forth information on the Company's TDRs, on a disaggregated basis, occurring in the three and nine months ended September 30, 2014 and 2013: (*dollars in thousands*)

	Three Months Ended September 30,							
	2014		2013					
	Pre-Modification Outstanding	Post-Modification Outstanding	Pre-Modification Outstanding	Post-Modification Outstanding				
	Number of Recorded Contracts	Investment	Number of Recorded Contracts	Investment				
Real estate - construction	- \$	-	\$	-	- \$	-	\$	-
Real estate - 1 to 4 family residential	1	25	25	-	-	-	-	-
Real estate - commercial	-	-	-	-	-	-	-	-
Real estate - agricultural	-	-	-	-	-	-	-	-
Commercial	-	-	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-	-	-
Consumer and other	-	-	-	-	-	-	-	-
	1	\$ 25	\$ 25	-	\$ -	-	\$ -	-

	Nine Months Ended September 30,							
	2014		2013					
	Pre-Modification Outstanding	Post-Modification Outstanding	Pre-Modification Outstanding	Post-Modification Outstanding				
	Number of Recorded Contracts	Investment	Number of Recorded Contracts	Investment				
Real estate - construction	- \$	-	\$	-	- \$	-	\$	-
Real estate - 1 to 4 family residential	1	25	25	-	-	-	-	-
Real estate - commercial	1	43	43	-	-	-	-	-
Real estate - agricultural	-	-	-	-	-	-	-	-
Commercial	-	-	-	1	130	130	-	-
Agricultural	1	19	19	-	-	-	-	-
Consumer and other	1	6	6	-	-	-	-	-
	4	\$ 93	\$ 93	1	\$ 130	130	\$	130

The Company restructured one loan during the three months ended September 30, 2014. During the nine months ended September 30, 2014, the Company granted concessions to three borrowers experiencing financial difficulties. A

commercial real estate loan was restructured as an interest only loan for a period of time. An agricultural and consumer loans maturity date was extended one year with interest only until maturity. A 1-4 family residential loans terms were extended beyond normal terms.

There was no new TDR activity in the three months ended September 30, 2013. However, during the nine months ended September 30, 2013, the Company restructured one loan by granting concessions to a borrower experiencing financial difficulties. The loan was restricted with a collateral shortfall.

A TDR loan is considered to have payment default when it is past due 60 days or more.

No TDR loan modified during the twelve months ended September 30, 2014 had a payment default. Two TDR loans modified during the twelve months ended September 30, 2013 had payment defaults. These modified TDR loans had a balance as of September 30, 2013 of \$132,000.

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There was two charge-off related to TDRs for the nine months ended September 30, 2014 in the amount of \$48,000 and no charge-offs related to TDRs for the nine months ended September 30, 2013. For the nine months ended September 30, 2014, the specific reserves were reduced by \$100,000 as a result of one TDR that is no longer considered impaired. For the nine months ended September 30, 2013, there was no impact on specific reserves due to TDRs.

An aging analysis of the recorded investments in loans, on a disaggregated basis, as of September 30, 2014 and December 31, 2013, is as follows: (*in thousands*)

2014

	30-89 Past Due	90 Days or Greater Past Due	Total Past Due	Current	Total	90 Days or Greater Accruing
Real estate - construction	\$-	\$ -	\$-	\$33,386	\$33,386	\$ -
Real estate - 1 to 4 family residential	1,031	114	1,145	134,142	135,287	-
Real estate - commercial	277	159	436	222,676	223,112	-
Real estate - agricultural	-	-	-	55,297	55,297	-
Commercial	822	89	911	88,028	88,939	-
Agricultural	-	-	-	73,594	73,594	-
Consumer and other	40	-	40	14,641	14,681	-
	\$2,170	\$ 362	\$2,532	\$621,764	\$624,296	\$ -

2013

	30-89 Past Due	90 Days or Greater Past Due	Total Past Due	Current	Total	90 Days or Greater Accruing
Real estate - construction	\$-	\$-	\$-	\$23,928	\$23,928	\$ -
Real estate - 1 to 4 family residential	1,059	4,000	5,059	103,231	108,290	27
Real estate - commercial	-	46	46	206,065	206,111	-
Real estate - agricultural	-	-	-	53,834	53,834	-
Commercial	88	375	463	86,360	86,823	-
Agricultural	-	-	-	81,326	81,326	-
Consumer and other	35	-	35	12,760	12,795	-
	\$1,182	\$4,421	\$5,603	\$567,504	\$573,107	\$ 27

The credit risk profile by internally assigned grade, on a disaggregated basis, as of September 30, 2014 and December 31, 2013 is as follows: *(in thousands)*

2014

	Construction Real Estate	Commercial Real Estate	Agricultural Real Estate	Commercial	Agricultural	Total
Pass	\$ 27,123	\$ 187,646	\$ 51,819	\$ 74,659	\$ 69,265	\$410,512
Watch	2,826	19,371	3,367	10,310	4,056	39,930
Special Mention	-	1,130	-	567	88	1,785
Substandard	3,025	14,101	111	2,679	166	20,082
Substandard-Impaired	412	864	-	724	19	2,019
	\$ 33,386	\$ 223,112	\$ 55,297	\$ 88,939	\$ 73,594	\$474,328

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2013

	Construction Real Estate	Commercial Real Estate	Agricultural Real Estate	Commercial	Agricultural	Total
Pass	\$ 16,887	\$ 169,659	\$ 51,486	\$ 73,073	\$ 78,476	\$389,581
Watch	3,545	20,267	2,051	10,717	1,963	38,543
Special Mention	-	798	-	796	9	1,603
Substandard	2,986	14,862	297	1,421	854	20,420
Substandard-Impaired	510	526	-	816	24	1,876
	\$ 23,928	\$ 206,112	\$ 53,834	\$ 86,823	\$ 81,326	\$452,023

The credit risk profile based on payment activity, on a disaggregated basis, as of September 30, 2014 and December 31, 2013 is as follows:

2014

	1-4 Family Residential Real Estate	Consumer and Other	Total
Performing	\$ 134,817	\$ 14,672	\$ 149,489
Non-performing	470	9	479
	\$ 135,287	\$ 14,681	\$ 149,968

2013

	1-4 Family Residential Real Estate	Consumer and Other	Total
Performing	\$ 107,667	\$ 12,740	\$ 120,407
Non-performing	623	55	678
	\$ 108,290	\$ 12,795	\$ 121,085

9. Other Real Estate Owned

The following table provides the composition of other real estate owned as of September 30, 2014 and December 31, 2013: *(in thousands)*

	2014	2013
Construction and land development	\$7,064	\$6,751
1 to 4 family residential real estate	1,343	1,296
Commercial real estate	1,781	814
	\$10,188	\$8,861

The Company is actively marketing the assets referred in the table above. Management uses appraised values and adjusts for trends observed in the market and for disposition costs in determining the value of other real estate owned. The assets above are primarily located in the metropolitan Des Moines, Iowa and Ames, Iowa areas.

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10. Goodwill

As of August 29, 2014, FNB acquired three bank branches located in West Des Moines and Johnston, Iowa, which resulted in the recognition of \$1.1 million of goodwill. Goodwill recognized in the Acquisition was primarily attributable to an expanded market share and economies of scale expected from combining the operations of the West Des Moines and Johnston, Iowa branches with FNB. Goodwill was also recognized in 2012 due to an acquisition which resulted in an expanded market area. The goodwill resulted from a premium paid related to these acquisitions. The goodwill is not amortized but is evaluated for impairment at least annually. For income tax purposes, goodwill is amortized over fifteen years.

11. Core deposit intangible asset

In conjunction with the Acquisition of the three bank branches in 2014, the Company recorded \$1.0 million in core deposit intangible assets. In conjunction with the 2012 acquisition, the Company recorded a \$1.5 million core deposit intangible asset. The following sets forth the carrying amounts and accumulated amortization of core deposit intangible assets at September 30, 2014 and December 31, 2013: *(in thousands)*

	2014		2013	
	Gross Amount	Accumulated Amortization	Gross Amount	Accumulated Amortization
Core deposit intangible asset	\$ 2,518	\$ 674	\$ 1,500	\$ 470

The weighted average life of the core deposit intangible is 4 years and 5 years as of September 30, 2014 and December 31, 2013, respectively.

The following sets forth the activity related to core deposit intangible assets for the three and nine months ended September 30, 2014 and 2013: *(in thousands)*

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	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Beginning core deposit intangible, net	\$903	\$1,161	\$1,030	\$1,303
Purchases	1,018	-	1,018	-
Amortization	(77)	(66)	(204)	(208)
Ending core deposit intangible, net	\$1,844	\$1,095	\$1,844	\$1,095

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Estimated remaining amortization expense on core deposit intangible for the years ending is as follows: *(in thousands)*

2014	\$113
2015	422
2016	354
2017	299
2018	251
2019	127
After	278
	\$1,844

12. Subsequent Events

Management evaluated subsequent events through the date the financial statements were issued. There were no significant events or transactions occurring after September 30, 2014, but prior to November 7, 2014, that provided additional evidence about conditions that existed at September 30, 2014. There were no other significant events or transactions that provided evidence about conditions that did not exist at September 30, 2014.

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

Overview

Ames National Corporation (the “Company”) is a bank holding company established in 1975 that owns and operates five bank subsidiaries in central Iowa (the “Banks”). 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), Reliance State Bank (Reliance 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 wealth management 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 211 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.

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The principal sources of Company revenues and cash flow are: (i) interest and fees earned on loans made by the Company and Banks; (ii) interest on fixed income investments held by the Company and Banks; (iii) fees on wealth management services provided by those Banks exercising trust powers; (iv) service charges on deposit accounts maintained at the Banks and (v) ATM and card fees. The Company's principal expenses are: (i) interest expense on deposit accounts and other borrowings; (ii) provision for loan losses; (iii) salaries and employee benefits; (iv) data processing costs associated with maintaining the Banks' loan and deposit functions; and (v) 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.

On August 29, 2014, First National purchased substantially all of the assets, including loans, and assumed substantially all of the liabilities, including deposit accounts, of First Bank., an Iowa state chartered bank located in West Des Moines, Iowa for \$4.1 million. First National will operate all three bank offices previously operated by First Bank in West Des Moines, Iowa and Johnston, Iowa.

The Company had net income of \$3,731,000, or \$0.40 per share, for the three months ended September 30, 2014, compared to net income of \$3,712,000, or \$0.40 per share, for the three months ended September 30, 2013. Total equity capital as of September 30, 2014 totaled \$154.0 million or 11.9% of total assets.

The increase in quarterly earnings can be primarily attributed to increases in loan and taxable securities available-for-sale interest income, offset in part by increases in noninterest expenses.

Net loan charge-offs totaled \$42,000 and \$8,000 for the three months ended September 30, 2014 and 2013, respectively. The provision for loan losses totaled \$55,000 and \$92,000 for the three months ended September 30, 2014 and 2013, respectively.

The Company had net income of \$12,113,000, or \$1.30 per share, for the nine months ended September 30, 2014, compared to net income of \$10,577,000, or \$1.14 per share, for the nine months ended September 30, 2013.

The increase in the nine months earnings can be primarily attributed to increases in loan and taxable securities available-for-sale interest income, the gain on the sale of premises and equipment and a decrease in the other real estate owned expenses. The Company sold its office location near Iowa State University in Ames, Iowa (University office), but the Company will maintain a presence near the campus. Excluding the after tax one-time gain on the sale

of premises and equipment, net income of \$11,334,000 or \$1.22 per share in 2014, would have still exceeded 2013 earnings of \$10,577,000, or \$1.14 per share, a 7% increase.

Net loan charge-offs totaled \$172,000 and \$36,000 for the nine months ended September 30, 2014 and 2013, respectively. The provision for loan losses totaled \$130,000 and \$166,000 for the nine months ended September 30, 2014 and 2013, respectively.

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

Challenges

Key Performance Indicators and Industry Results

Critical Accounting Policies

Income Statement Review

Balance Sheet Review

Asset Quality Review and Credit Risk Management

Liquidity and Capital Resources

Forward-Looking Statements and Business Risks

Table Of Contents**Challenges**

Management has identified certain events or circumstances that may negatively impact the Company's financial condition and results of operations in the future and is attempting to position the Company to best respond to those challenges. These challenges are addressed in the Company's most recent Annual Report on Form 10-K filed on March 12, 2014.

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 (the "FDIC") and are derived from 6,656 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

	3 Months Ended September 30, 2014		9 Months Ended June 30, 2014		3 Months Ended June 30, 2014		Years Ended December 31,			
	Company	Industry	Company*	Industry	Company	Industry	Company	Industry	Company	Industry
Return on assets	1.20 %	1.29 %	1.23 %	1.04 %	1.14 %	1.07 %	1.24 %	1.00 %		
Return on equity	9.73 %	10.78 %	10.27 %	9.27 %	9.76 %	9.56 %	10.08 %	8.92 %		
Net interest margin	3.32 %	3.29 %	3.30 %	3.16 %	3.18 %	3.26 %	3.35 %	3.42 %		
Efficiency ratio	52.24 %	49.35 %	50.49 %	60.96 %	52.78 %	60.54 %	52.33 %	61.60 %		
Capital ratio	12.28 %	12.00 %	12.01 %	9.57 %	11.67 %	9.41 %	12.31 %	9.15 %		

*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 1.20% and 1.24% for the three months ended September 30, 2014 and 2013, respectively. The decrease in this ratio in 2014 from the previous period is due to an increase in average assets in 2014, with net income remaining relatively unchanged.

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 9.73% and 10.77% for the three months ended September 30, 2014 and 2013, respectively. The decrease in this ratio in 2014 from the previous period is due to an increase in the average equity due in part to net income, reduced by dividends, and an increase in the accumulated other comprehensive income.

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Net Interest Margin

The net interest margin for the three months ended September 30, 2014 and 2013 was 3.32% and 3.28%, respectively. 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 increase in this ratio in 2014 is primarily the result of an increase in the average balance of loans and higher yields on taxable securities available-for-sale.

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 52.24% and 50.63% for the three months ended September 30, 2014 and 2013, respectively. The change in the efficiency ratio in 2014 from the previous period is primarily the result of increased net interest income.

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 of 12.28% as of September 30, 2014 is significantly higher than the industry average as of June 30, 2014.

Industry Results

The FDIC Quarterly Banking Profile reported the following results for the second quarter of 2014:

Lower Expenses Contribute to Improvement in Earnings

The impact of the rise in medium-and long-term interest rates in second quarter 2013 remained evident in year-over-year earnings comparisons in second quarter 2014. The negative effect on noninterest income, particularly income from mortgage lending and from trading, was greater at large banks, while the positive implications of a steeper yield curve for net interest margins, combined with strengthening loan growth, were more significant for smaller institutions. The 6,656 FDIC-insured institutions filing financial results for second quarter 2014 reported combined net income of \$40.2 billion. This is \$2 billion (5.3%) more than the industry reported in second quarter 2013. Net operating revenue (the sum of net interest income and total noninterest income) was \$1.5 billion (0.9%) lower than in second quarter 2013, as a decline in noninterest income from mortgage sales, securitization and servicing outweighed an increase in net interest income. Earnings benefited from lower expenses for loan-loss provisions, goodwill impairment, and payrolls. A majority of banks—57.5%—reported year-over-year increases in quarterly earnings, and only 6.8% of banks were unprofitable, down from 8.4% a year ago. This is the lowest proportion of unprofitable institutions since first quarter 2006. The average return on assets for the quarter was 1.07%, slightly above the 1.06% average in the year-ago quarter.

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Revenues Decline From Year-Ago Level for Fourth Consecutive Quarter

Net interest income posted the largest year-over-year increase in 14 quarters, rising by \$2 billion (1.9%), as interest-earning assets were 6.4% above year-ago levels. Almost 72% of all institutions reported year-over-year growth in quarterly net interest income. The average net interest margin fell to 3.15% from 3.25% in second quarter 2013. This is the lowest quarterly margin for the industry since third quarter 1989. Margin pressure was most evident at large banks. Nine of the ten largest banks reported lower quarterly margins than a year ago, whereas 55.2% of all banks reported year-over-year margin increases. Noninterest income was \$3.6 billion (5.3%) lower than a year earlier, as income from sales, securitization, and servicing of 1-to-4 family residential mortgages fell by \$3.7 billion (42.5%). Trading income declined for a fourth consecutive quarter, falling by \$721 million (10.1%). Reduced expenses outweighed the weakness in revenues compared with the year before. Banks set aside \$6.6 billion in provisions for loan and lease losses during the quarter, a \$1.9 billion (22.4%) decline from second quarter 2013 and the lowest quarterly provision total since second quarter 2006. Expenses for goodwill impairment totaled \$192 million, down from \$4.4 billion in second quarter 2013, when two institutions reported large impairment charges. Expenses for salaries and employee benefits were \$399 million (0.8%) lower as the industry reported 37,282 fewer employees than the year before. Itemized litigation expenses were \$2 billion higher than in second quarter 2013.

Charge-Offs Fall to Seven-Year Low

Loan losses declined year over year for a 16th consecutive quarter, falling to \$9.9 billion from \$14.1 billion in second quarter 2013. This is the lowest quarterly net charge-off total for the industry since second quarter 2007. The decline was led by 1-to-4 family residential mortgage loans, where net charge-offs fell by \$2.2 billion (74.7%). Net charge-offs were down year over year in all major loan categories except auto loans, where charge-offs increased \$31 million (10.4%). Slightly more than half of all banks—50.8%—reported lower quarterly net charge-offs than in second quarter 2013.

Noncurrent Loan Rate Falls to Six-Year Low

Noncurrent loan balances improved for a 17th consecutive quarter, falling by \$13.4 billion (6.9%) during the three months ended June 30. Noncurrent balances declined in all major loan categories except auto loans, where they increased by \$28 million (3.2%). The largest decline occurred in noncurrent 1-to-4 family residential mortgages, which fell by \$8 billion (6.4%). Noncurrent real estate loans secured by nonfarm nonresidential properties fell by \$1.9 billion (9.6%), and noncurrent real estate construction loans declined by \$1.2 billion (15.9%). At the end of the quarter, the industry's noncurrent loan rate was 2.24%, the lowest level since second quarter 2008.

Reserve Coverage of Noncurrent Loans Improves for Seventh Consecutive Quarter

Loan-loss reserves declined for a 17th consecutive quarter, as charge-offs removed more from reserves than banks added in provisions. Reserve balances fell by \$4.1 billion (3.1%) during the quarter, as net charge-offs exceeded loss provisions by \$3.3 billion. More than one-third of all banks (38.3%) reduced their loan-loss reserves. Despite the decline in reserves, the industry's coverage ratio of reserves to noncurrent loans and leases rose from 67.8% to 70.5%, thanks to the larger reduction in noncurrent loan balances. This is the seventh consecutive quarter that the coverage ratio has improved. The ratio is at its highest level since year-end 2008.

Rebound in Securities Values Bolsters Equity Growth

Equity capital rose by \$34.2 billion (2%) during the quarter. Retained earnings added \$17.6 billion to equity growth. Lower interest rates produced a \$20 billion increase in unrealized gains on available-for-sale securities, which also contributed to the growth in equity. In addition, goodwill increased by \$3.8 billion (1.3%). Tier 1 regulatory capital, unaffected by changes in unrealized securities gains and goodwill, increased by \$19.8 billion (1.4%). The average equity-to-asset ratio rose from 11.23% to 11.26%, the highest level in almost two years. The average Tier 1 leverage ratio rose from 9.54% to 9.57%, the highest level for this regulatory capital ratio since risk-based capital standards were enacted in 1991. Insured institutions declared \$22.6 billion in dividends in second quarter, up from \$20.9 billion in second quarter 2013. At the end of the quarter, 98.4% of all insured institutions, representing 99.8% of all insured institution assets, met or exceeded the requirements for the highest regulatory capital category as defined for Prompt Corrective Action purposes.

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Increase in Loan Balances Is Largest Since 2007

Total assets increased by \$263.1 billion (1.8%), as loan and lease balances grew by \$178.5 billion (2.3%), investment securities portfolios rose by \$58.6 billion (1.9%), and balances at Federal Reserve banks increased by \$28.2 billion (2.3%). The growth in loan balances was the largest quarterly increase since fourth quarter 2007 (excluding a change in accounting rules in first quarter 2010). Loan growth was led by commercial and industrial loans (up \$49.9 billion, 3.1%), 1-to-4 family residential mortgages (up \$22.7 billion, 1.2%), credit card balances (up \$20 billion, 3%), and auto loans (up \$10.9 billion, 3%). All major loan categories posted increases during the quarter except home equity lines of credit (down \$4.4 billion, 0.9%). Loans to small businesses and farms rose by \$8.2 billion (1.3%), the largest quarterly increase since banks began reporting small-business loan data on a quarterly basis in 2010. Banks' holdings of available-for-sale securities increased by \$13.9 billion (0.6%), as a result of a \$20 billion increase in their market values; the book value of the industry's available-for-sale portfolio registered a slight \$6.1 billion decline. In contrast, banks increased their portfolios of held-to-maturity securities by \$44.7 billion (8.3%). Unfunded loan commitments increased by \$132.2 billion (2.1%), the largest quarterly increase since first quarter 2010. Growth in unfunded commitments was led by a \$44.5 billion (2.8%) increase in unfunded commercial and industrial loan commitments.

Large Denomination Noninterest-Bearing Deposits Post Strong Growth

Total deposits increased by \$172.4 billion (1.5%) in the quarter. Growth was led by balances in accounts larger than \$250,000, which increased by \$157.5 billion (3.2%). Balances in domestic deposit accounts of \$250,000 or less declined by \$13.5 billion (0.3%). Noninterest-bearing accounts in domestic offices were up \$115 billion (4.3%), while deposits in foreign offices rose by \$35.8 billion (2.6%). Nondeposit interest-bearing liabilities increased by \$56.5 billion (3%), as banks increased their borrowings from Federal Home Loan Banks by \$45.6 billion (11.6%). Almost 90% of the growth in FHLB advances consisted of short-term borrowings (maturing or repricing in one year or less). Banks also increased their unsecured nondeposit borrowings that mature in one to three years by \$17.5 billion (21.7%). Almost 90% of the \$228.9 billion increase in liabilities during the quarter consisted of liabilities maturing or repricing in one year or less.

“Problem List” Shrinks to Smallest Level in Over Five Years

The number of insured institutions filing quarterly financial reports declined from 6,730 to 6,656 in the second quarter. Mergers absorbed 61 institutions during the quarter, while seven institutions failed. No new charters were added in the quarter. The number of institutions on the FDIC's “Problem List” declined from 411 to 354. This is the smallest number of “problem” institutions since the end of first quarter 2009, and is 60% below the most recent peak level of 888 “problem” institutions at the end of first quarter 2011. Total assets of “problem” institutions declined from \$126.1 billion to \$110.2 billion. The number of full-time equivalent employees at FDIC-insured institutions increased from 2,058,867 to 2,060,002, but remained below the year-earlier level of 2,097,284.

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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 December 31, 2013 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 Annual Report. Based on its consideration of accounting policies that involve the most complex and subjective estimates and judgments, management has identified its most critical accounting policies to be those related to the allowance for loan losses, valuation of other real estate owned, the assessment of other-than-temporary impairment of certain securities available-for-sale and the valuation of goodwill.

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 collectability 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. Due to potential changes in conditions, it is at least reasonably possible that change in estimates will occur in the near term and that such changes could be material to the amounts reported in the Company's financial statements.

Other Real Estate Owned

Real estate properties acquired through or in lieu of foreclosure are initially recorded at the fair value less estimated selling cost at the date of foreclosure. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, independent appraisals or evaluations are periodically

performed by management and property held for sale is carried at the lower of the new cost basis or fair value less cost to sell. Impairment losses are measured as the amount by which the carrying amount of a property exceeds its fair value, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost basis or fair value less cost to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized. The appraisals or evaluations are inherently subjective and require estimates that are susceptible to significant revisions as more information becomes available. Due to potential changes in conditions, it is at least reasonably possible that changes in fair values will occur in the near term and that such changes could materially affect the amounts reported in the Company's financial statements.

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Other-Than-Temporary Impairment of Available-for-Sale Securities

Declines in the fair value of securities available-for-sale below their cost that are deemed to be other-than-temporary are generally reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers: (1) the intent to sell the investment securities and the more likely than not requirement that the Company will be required to sell the investment securities prior to recovery; (2) the length of time and the extent to which the fair value has been less than cost; and (3) the financial condition and near-term prospects of the issuer. Due to potential changes in conditions, it is at least reasonably possible that change in management's assessment of other-than-temporary impairment will occur in the near term and that such changes could be material to the amounts reported in the Company's financial statements.

Goodwill

Goodwill arose in connection with two acquisitions. For the purposes of goodwill impairment testing, determination of the fair value of the reporting units involves the use of significant estimates and assumptions. Through September 30, 2014, no conditions indicated impairment has incurred. The next annual test will be performed in the fourth quarter of 2014. Actual future test results may differ from the present evaluation of impairment due to changes in the conditions used at the time of that evaluation.

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The following highlights a comparative discussion of the major components of net income and their impact for the three months ended September 30, 2014 and 2013:

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,					
	2014			2013		
	Average balance	Revenue/ expense	Yield/ rate	Average balance	Revenue/ expense	Yield/ rate
ASSETS						
<i>(dollars in thousands)</i>						
Interest-earning assets						
Loans 1						
Commercial	\$86,166	\$ 950	4.41 %	\$77,574	\$ 964	4.97 %
Agricultural	71,628	859	4.79 %	68,159	903	5.30 %
Real estate	413,355	4,745	4.59 %	368,220	4,503	4.89 %
Consumer and other	14,163	168	4.74 %	14,522	199	5.49 %
Total loans (including fees)	585,312	6,722	4.59 %	528,475	6,569	4.97 %
Investment securities						
Taxable	302,713	1,792	2.37 %	293,262	1,400	1.91 %
Tax-exempt 2	272,817	2,366	3.47 %	297,021	2,608	3.51 %
Total investment securities	575,530	4,158	2.89 %	590,283	4,008	2.72 %
	26,386	67	1.01 %	31,061	86	1.11 %

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Interest bearing deposits with banks and federal funds sold

Total interest-earning assets	1,187,228	\$ 10,947	3.69 %	1,149,819	\$ 10,663	3.71 %
Noninterest-earning assets	61,693			51,489		