AMES NATIONAL CORP
Form 10-K
March 10, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2009. Commission File Number 0-32637.

AMES NATIONAL CORPORATION
(Exact name of registrant as specified in its charter)

IOWA (State or other jurisdiction of incorporation or organization)	42-1039071 (I.R.S. Employer Identification No.)
405 FIFTH STREET, AMES, IOWA (Address of principal executive offices)	50010 (Zip Code)

(515) 232-6251
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Exchange Act: NONE

Securities registered pursuant to Section 12(g) of the Exchange Act:

COMMON STOCK, $2.00 PAR VALUE
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 ¨

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 during the preceding 12 months (of for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer ¨ Accelerated filer x 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 x

As of June 30, 2009, the aggregate market value of voting stock held by non-affiliates of the registrant, based upon the closing sale price for the registrant's common stock in the NASDAQ Capital Market, was $217,515,875. Shares of common stock beneficially owned by each executive officer and director of the Company and by each person who beneficially owns 5% or more of the outstanding common stock have been excluded on the basis that such persons may be deemed to be an affiliate of the registrant. This determination of affiliate status is not necessarily a conclusive determination for any other purpose.

The number of shares outstanding of the registrant's Common stock on February 26, 2010, was 9,432,915.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement, as filed with the Securities and Exchange Commission on March 19, 2010, are incorporated by reference into Part III of this Form 10-K.

TABLE OF CONTENTS

Part I

Item 1.	Business
Item 1A.	Risk Factors
Item 1B.	Unresolved Staff Comments
Item 2.	Properties
Item 3.	Legal Proceedings
Item 4.	Reserved

Part II

Item 5.	Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities
Item 6.	Selected Financial Data
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations
Item 7A.	Quantitative and Qualitative Disclosures about Market Risk
Item 8.	Financial Statements and Supplementary Data
Item 9	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
Item 9A.	Controls and Procedures
Item 9B.	Other Information

Part III

Item 10.	Directors, Executive Officers and Corporate Governance
Item 11.	Executive Compensation
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters
Item 13.	Certain Relationships and Related Transactions and Director Independence
Item 14.	Principal Accountant Fees and Services

Part IV

Item 15.	Exhibits and Financial Statement Schedules

Table of Contents

PART I

ITEM 1. BUSINESS

General

Ames National Corporation (the "Company") is an Iowa corporation and bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company owns 100% of the stock of five banking subsidiaries consisting of two national banks and three state-chartered banks, as described below. All of the Company’s operations are conducted in the State of Iowa and primarily within the central Iowa counties of Boone, Marshall, Polk and Story where the Company’s banking subsidiaries are located. The Company does not engage in any material business activities apart from its ownership of its banking subsidiaries. The principal executive offices of the Company are located at 405 Fifth Street, Ames, Iowa 50010. The company’s telephone number is (515) 232-6251 and website address is www.amesnational.com.

The Company was organized and incorporated on January 21, 1975 under the laws of the State of Iowa to serve as a holding company for its principal banking subsidiary, First National Bank, Ames, Iowa ("First National") located in Ames, Iowa. In 1983, the Company acquired the stock of the State Bank & Trust Co. ("State Bank") located in Nevada, Iowa; in 1991, the Company, through a newly-chartered state bank known as Boone Bank & Trust Co. ("Boone Bank"), acquired certain assets and assumed certain liabilities of the former Boone State Bank & Trust Company located in Boone, Iowa; in 1995, the Company acquired the stock of the Randall-Story State Bank (”Randall-Story Bank”) located in Story City, Iowa; and in 2002, the Company chartered and commenced operations of a new national banking organization, United Bank & Trust NA (“United Bank”), located in Marshalltown, Iowa. First National, State Bank, Boone Bank, Randall-Story Bank and United Bank are each operated as a wholly owned subsidiary of the Company. These five financial institutions are referred to in this Form 10-K collectively as the “Banks” and individually as a “Bank”.

The principal sources of Company revenue are: (i) interest and fees earned on loans made by the Banks; (ii) service charges on deposit accounts maintained at the Banks; (iii) interest on fixed income investments held by the Company and the Banks; (iv) fees on trust services provided by those Banks exercising trust powers; and (v) securities gains.

The Banks’ lending activities consist primarily of short-term and medium-term commercial and residential real estate loans, agricultural and business operating loans and lines of credit, equipment loans, vehicle loans, personal loans and lines of credit, home improvement loans and origination of mortgage loans for sale into the secondary market. The Banks also offer a variety of demand, savings and time deposits, cash management services, merchant credit card processing, safe deposit boxes, wire transfers, direct deposit of payroll and social security checks and automated teller machine access. Four of the five Banks also offer trust services.

The Company provides various services to the Banks which include, but are not limited to, management assistance, internal auditing services, human resources services and administration, compliance management, marketing assistance and coordination, loan review and assistance with respect to computer systems and related procedures.

Table of Contents

Banking Subsidiaries

First National Bank, Ames, Iowa. First National is a nationally-chartered, commercial bank insured by the Federal Deposit Insurance Corporation (the "FDIC"). It was organized in 1903 and became a wholly owned subsidiary of the Company in 1975 through a bank holding company reorganization whereby the then shareholders of First National exchanged all of their First National stock for stock in the Company. First National provides full-service banking to businesses and residents within the Ames community and surrounding area. It provides a variety of products and services designed to meet the needs of the market it serves. It has an experienced staff of bank officers including many who have spent the majority of their banking careers with First National and who emphasize long-term customer relationships. First National conducts business out of three full-service offices and one super market location, all located in the city of Ames and a full-service office built in Ankeny, Iowa that opened in April of 2007.

As of December 31, 2009, First National had capital of $45,839,000 and 94 full-time equivalent employees. Full-time equivalents represent the number of people a business would employ if all its employees were employed on a full-time basis. It is calculated by dividing the total number of hours worked by all full and part-time employees by the number of hours a full-time individual would work for a given period of time. First National had net income for the years ended December 31, 2009, 2008 and 2007 of approximately $5,309,000, $1,237,000 and $5,887,000, respectively. Total assets as of December 31, 2009, 2008 and 2007 were approximately $471,243,000, $445,212,000 and $466,908,000, respectively.

State Bank & Trust Co., Nevada, Iowa. State Bank is an Iowa, state-chartered, FDIC insured commercial bank. State Bank was acquired by the Company in 1983 through a stock transaction whereby the then shareholders of State Bank exchanged all their State Bank stock for stock in the Company. State Bank was organized in 1939 and provides full-service banking to businesses and residents within the Nevada area from its main Nevada location and two offices, one in McCallsburg, Iowa and the other in Colo, Iowa. It has a strong presence in agricultural, commercial and residential real estate lending.

As of December 31, 2009, State Bank had capital of $13,084,000 and 23 full-time equivalent employees. State Bank had net income for the years ended December 31, 2009, 2008 and 2007 of approximately $1,462,000, $1,738,000 and $1,352,000, respectively. Total assets as of December 31, 2009, 2008 and 2007 were approximately $134,947,000, $121,792,000 and $107,585,000, respectively.

Boone Bank & Trust Co., Boone, Iowa. Boone Bank is an Iowa, state-chartered, FDIC insured commercial bank. Boone Bank was organized in 1992 by the Company under a new state charter in connection with a purchase and assumption transaction whereby Boone Bank purchased certain assets and assumed certain liabilities of the former Boone State Bank & Trust Company in exchange for a cash payment. It provides full service banking to businesses and residents within the Boone community and surrounding area. It is actively engaged in agricultural, consumer and commercial lending, including real estate, operating and equipment loans. It conducts business from its main office and a full service branch office, both located in Boone.

As of December 31, 2009, Boone Bank had capital of $12,766,000 and 25 full-time equivalent employees. Boone Bank had net income for the years ended December 31, 2009, 2008 and 2007 of approximately $1,473,000, $1,406,000 and $1,586,000, respectively. Total assets as of December 31, 2009, 2008 and 2007 were approximately $104,957,000, $101,882,000 and $97,574,000, respectively.

Table of Contents

Randall-Story State Bank, Story City, Iowa. Randall-Story Bank is an Iowa, state-chartered, FDIC insured commercial bank. Randall-Story Bank was acquired by the Company in 1995 through a stock transaction whereby the then shareholders of Randall-Story Bank exchanged all their Randall-Story Bank stock for stock in the Company. Randall-Story Bank was organized in 1928 and provides full-service banking to Story City and the surrounding area. While its primary emphasis is in agricultural lending, Randall-Story Bank also provides the traditional lending services typically offered by community banks.

As of December 31, 2009, Randall-Story Bank had capital of $8,499,000 and 13 full-time equivalent employees. Randall-Story Bank had net income for the years ended December 31, 2009, 2008 and 2007 of approximately $888,000, $831,000 and $969,000, respectively. Total assets as of December 31, 2009, 2008 and 2007 were approximately $79,497,000, $78,199,000 and $72,762,000, respectively.

United Bank & Trust NA, Marshalltown, Iowa. United Bank is a nationally-chartered, commercial bank insured by the FDIC. It was newly chartered in June of 2002 and offers a broad range of deposit and loan products, as well as trust services to customers located in the Marshalltown and surrounding Marshall County area.

As of December 31, 2009, United Bank had capital of $9,425,000 and 20 full-time equivalent employees. United Bank had net income (loss) for the years ended December 31, 2009, 2008 and 2007 of approximately $387,000, $(87,000) and $104,000, respectively. Total assets as of December 31, 2009, 2008 and 2007 were approximately $112,441,000, $99,441,000 and $106,736,000, respectively.

Business Strategy and Operations

As a locally owned, multi-bank holding company, the Company emphasizes strong personal relationships to provide products and services that meet the needs of the Banks' customers. The Company seeks to achieve growth and maintain a strong return on equity. To accomplish these goals, the Banks focus on small-to-medium size businesses that traditionally wish to develop an exclusive relationship with a single bank. The Banks, individually and collectively, have the size to give the personal attention required by business owners, in addition to the credit expertise to help businesses meet their goals.

The Banks offer a full range of deposit services that are typically available in most financial institutions, including checking accounts, savings accounts and time deposits of various types, ranging from money market accounts to longer-term certificates of deposit. One major goal in developing the Banks' product mix is to keep the product offerings as simple as possible, both in terms of the number of products and the features and benefits of the individual services. The transaction accounts and time certificates are tailored to each Bank's principal market area at rates competitive in that Bank's market. In addition, retirement accounts such as IRAs (Individual Retirement Accounts) are available. The FDIC insures all deposit accounts up to the maximum amount. The Banks solicit these accounts from small-to-medium sized businesses in their respective primary trade areas, and from individuals who live and/or work within these areas. No material portion of the Banks' deposits has been obtained from a single person or from a few persons. Therefore, the Company does not believe that the loss of the deposits of any person or of a few persons would have an adverse effect on the Banks' operations or erode their deposit base.

Table of Contents

Loans are provided to creditworthy borrowers regardless of their race, color, national origin, religion, sex, age, marital status, disability, receipt of public assistance or any other basis prohibited by law. The Banks intend to fulfill this commitment while maintaining prudent credit standards. In the course of fulfilling this obligation to meet the credit needs of the communities which they serve, the Banks give consideration to each credit application regardless of the fact that the applicant may reside in a low to moderate income neighborhood, and without regard to the geographic location of the residence, property or business within their market areas.

The Banks provide innovative, quality financial products, such as Internet banking and trust services that meet the banking needs of their customers and communities. The loan programs and acceptance of certain loans may vary from time-to-time depending on the funds available and regulations governing the banking industry. The Banks offer all basic types of credit to their local communities and surrounding rural areas, including commercial, agricultural and consumer loans. The types of loans within these categories are as follows:

Commercial Loans. Commercial loans are typically made to sole proprietors, partnerships, corporations and other business entities such as municipalities and individuals where the loan is to be used primarily for business purposes. These loans are typically secured by assets owned by the borrower and often times involve personal guarantees given by the owners of the business. The types of loans the Banks offer include:

- financing guaranteed under Small Business Administration programs
- operating and working capital loans
- loans to finance equipment and other capital purchases
- commercial real estate loans
- business lines of credit
- term loans
- loans to professionals
- letters of credit

Agricultural Loans. The Banks, by nature of their location in central Iowa, are directly and indirectly involved in agriculture and agri-business lending. This includes short-term seasonal lending associated with cyclical crop and livestock production, intermediate term lending for machinery, equipment and breeding stock acquisition and long-term real estate lending. These loans are typically secured by the crops, livestock, equipment or real estate being financed. The basic tenet of the Banks' agricultural lending philosophy is a blending of strong, positive cash flow supported by an adequate collateral position, along with a demonstrated capacity to withstand short-term negative impact if necessary. Applicable governmental subsidies and affiliated programs are utilized if warranted to accomplish these parameters. Approximately 17% of the loan portfolio consists of loans made for agricultural purposes. The Banks have not experienced a material adverse effect on their business as a result of defaults on agricultural loans and do not anticipate at the present time experiencing any such effect in the future.

Consumer Loans. Consumer loans are typically available to finance home improvements and consumer purchases, such as automobiles, household furnishings, boats and education. These loans are made on both a secured and an unsecured basis. The following types of consumer loans are available:

Table of Contents

- automobiles and trucks
- boats and recreational vehicles
- personal loans and lines of credit
- home equity lines of credit
- home improvement and rehabilitation loans
- consumer real estate loans

Other types of credit programs, such as loans to nonprofit organizations, to public entities, for community development and to other governmental offered programs also are available.

First National, Boone Bank, State Bank and United Bank offer trust services typically found in a commercial bank with trust powers, including the administration of estates, conservatorships, personal and corporate trusts and agency accounts. The Banks also provide farm management, investment and custodial services for individuals, businesses and non-profit organizations.

The Banks earn income from the origination of residential mortgages that are sold in the secondary real estate market without retaining the mortgage servicing rights.

The Banks offer traditional banking services, such as safe deposit boxes, wire transfers, direct deposit of payroll and social security checks, automated teller machine access and automatic drafts (ACH) for various accounts.

Credit Management

The Company strives to achieve sound credit risk management. In order to achieve this goal, the Company has established uniform credit policies and underwriting criteria for the Banks' loan portfolios. The Banks diversify in the types of loans offered and are subject to regular credit examinations, annual internal and external loan audits and annual review of large loans, as well as quarterly reviews of loans experiencing deterioration in credit quality. The Company attempts to identify potential problem loans early, charge off loans promptly and maintain an adequate allowance for loan losses. The Company has established credit guidelines for the Banks' lending portfolios which include guidelines relating to the more commonly requested loan types, as follows:

Commercial Real Estate Loans - Commercial real estate loans, including agricultural real estate loans, are normally based on loan to appraisal value ratios of 80% and secured by a first priority lien position. Loans are typically subject to interest rate adjustments no less frequently than 5 years from origination. Fully amortized monthly repayment terms normally do not exceed twenty years. Projections and cash flows that show ability to service debt within the amortization period are required. Property and casualty insurance is required to protect the Banks' collateral interests. Commercial and agricultural real estate loans represent approximately 46% of the loan portfolio. Major risk factors for commercial real estate loans, as well as the other loan types described below, include a geographic concentration in central Iowa; the dependence of the local economy upon several large governmental entities, including Iowa State University and the Iowa Department of Transportation; and the health of Iowa's agricultural sector that is dependent on weather conditions and government programs.

Table of Contents

Commercial and Agricultural Operating Lines - These loans are made to businesses and farm operations with terms up to twelve months. The credit needs are generally seasonal with the source of repayment coming from the entity's normal business cycle. Cash flow reviews are completed to establish the ability to service the debt within the terms of the loan. A first priority lien on the general assets of the business normally secures these types of loans. Loan to value limits vary and are dependent upon the nature and type of the underlying collateral and the financial strength of the borrower. Crop and hail insurance is required for most agricultural borrowers. Loans are generally guaranteed by the principal(s).

Commercial and Agricultural Term Loans – These loans are made to businesses and farm operations to finance equipment, breeding stock and other capital expenditures. Terms are generally the lesser of five years or the useful life of the asset. Term loans are normally secured by the asset being financed and are often additionally secured with the general assets of the business. Loan to value is generally 75% of the cost or value of the assets. Loans are normally guaranteed by the principal(s). Commercial and agricultural operating and term loans represent approximately 26% of the loan portfolio.

Residential First Mortgage Loans – Proceeds of these loans are used to buy or refinance the purchase of residential real estate with the loan secured by a first lien on the real estate. Most of the residential mortgage loans originated by the Banks (including servicing rights) are sold in the secondary mortgage market due to the higher interest rate risk inherent in the 15 and 30 year fixed rate terms consumers prefer. Loans that are originated and not sold in the secondary market generally have higher interest rates and have rate adjustment periods of no longer than seven years. The maximum amortization of first mortgage residential real estate loans is 30 years. The loan-to-value ratios normally do not exceed 80% without credit enhancements such as mortgage insurance. Property insurance is required on all loans to protect the Banks' collateral position. Loans secured by one to four family residential properties represent approximately 22% of the loan portfolio.

Home Equity Term Loans – These loans are normally for the purpose of home improvement or other consumer purposes and are secured by a junior mortgage on residential real estate. Loan-to-value ratios normally do not exceed 90% of market value.

Home Equity Lines of Credit - The Banks offer a home equity line of credit generally with a maximum term of 60 months. These loans are secured by a junior mortgage on the residential real estate and normally do not exceed a loan-to-market value ratio of 90% with the interest adjusted quarterly.

Consumer Loans – Consumer loans are normally made to consumers under the following guidelines. Automobiles - loans on new and used automobiles generally will not exceed 90% and 75% of the value, respectively. Recreational vehicles and boats – 90% and 66% of the value, respectively. Mobile home - maximum term on these loans is 180 months with the loan-to-value ratio generally not exceeding 66%. Each of these loans is secured by a first priority lien on the assets and requires insurance to protect the Banks' collateral position. Unsecured - The term for unsecured loans generally does not exceed 12 months. Consumer and other loans represent approximately 6% of the loan portfolio.

Table of Contents

Employees

At December 31, 2009, the Banks had a total of 175 full-time equivalent employees and the Company had an additional 12 full-time employees. The Company and Banks provide their employees with a comprehensive program of benefits, including comprehensive medical and dental plans, long-term and short-term disability coverage, and a 401(k) profit sharing plan. Management considers its relations with employees to be satisfactory. Unions represent none of the employees.

Market Area

The Company operates five commercial banks with locations in Story, Boone, Polk and Marshall Counties in central Iowa.

First National is located in Ames, Iowa with a population of 51,557. The major employers are Iowa State University, Ames Laboratories, Iowa Department of Transportation, Mary Greeley Medical Center, National Veterinary Services Laboratory, Ames Community Schools, City of Ames, Barilla, Sauer-Danfoss and McFarland Clinic. First National's primary business includes providing retail banking services and business and consumer lending. First National has a minimum exposure to agricultural lending.

Boone Bank is located in Boone, Iowa with a population of 12,803. Boone is the county seat of Boone County. The major employers are Fareway Stores, Inc., Iowa National Guard, Union Pacific Railroad, Boone County Hospital and Communication Data Services. Boone Bank provides lending services to the agriculture, commercial and real estate markets.

State Bank is located in Nevada, Iowa with a population of 6,658. Nevada is the county seat of Story County. The major employers are Print Graphics, General Financial Supply, Mid-American Manufacturing, Mid-States Millwright & Builders, Inc., Burke Corporation and Almaco. State Bank provides various types of loans with a major agricultural presence. It provides a wide variety of banking services including trust, deposit, ATM, and merchant card processing.

Randall-Story Bank is located in Story City, Iowa with a population of 3,228. The major employers are Bethany Manor, American Packaging, M.H. Eby, Inc. and Record Printing. Located in a major agricultural area, it has a strong presence in this type of lending. As a full service commercial bank, it provides a full line of products and services.

United Bank is located in Marshalltown, Iowa with a population of 25,957. The major employers are Iowa Veterans Home, Marshalltown School District, Swift & Co., Emerson Process Management/Fisher Division, Lennox Industries and Marshalltown Medical & Surgical Center. The Bank offers a full line of loan, deposit, and trust services. Loan services include primarily commercial and consumer types of credit including operating lines, equipment loans, automobile financing and real estate loans.

Competition

The geographic market area served by the Banks is highly competitive with respect to both loans and deposits. The Banks compete principally with other commercial banks, savings and loan associations, credit unions, mortgage companies, finance divisions of auto and farm equipment companies, agricultural suppliers and other financial service providers. Some of these competitors are local, while others are statewide or nationwide. The major commercial bank competitors include F & M Bank, U.S. Bank National Association and Wells Fargo Bank, each of which have a branch office or offices within the Banks' primary trade areas. Among the advantages such larger banks have are their ability to finance extensive advertising campaigns and to allocate their investment assets to geographic regions of higher yield and demand. These larger banking organizations have much higher legal lending limits than the Banks and thus are better able to finance large regional, national and global commercial customers.

Table of Contents

In order to compete with the other financial institutions in their primary trade areas, the Banks use, to the fullest extent possible, the flexibility which is accorded by independent status. This includes an emphasis on specialized services, local promotional activity and personal contacts by the Banks' officers, directors and employees. In particular, the Banks compete for deposits principally by offering depositors a wide variety of deposit programs, convenient office locations, hours and other services. The Banks compete for loans primarily by offering competitive interest rates, experienced lending personnel and quality products and services.

As of December 31, 2009, there were 32 FDIC insured institutions having approximately 86 offices or branch offices within Boone, Story, Polk and Marshall County, Iowa where the Banks' offices are primarily located. First National, State Bank and Randall-Story Bank together have the largest percentage of deposits in Story County.

The Banks also compete with the financial markets for funds. Yields on corporate and government debt securities and commercial paper affect the ability of commercial banks to attract and hold deposits. Commercial banks also compete for funds with equity, money market, and insurance products offered by brokerage and insurance companies. This competitive trend will likely continue in the future.

The Company anticipates bank competition will continue to change materially over the next several years as more financial institutions, including the major regional and national banks, continue to consolidate. Credit unions, which are not subject to income taxes, have a significant competitive advantage and provide additional competition in the Company’s local markets.

Supervision and Regulation

The following discussion generally refers to certain statutes and regulations affecting the banking industry. These references provide brief summaries and therefore do not purport to be complete and are qualified in their entirety by reference to those statutes and regulations. In addition, due to the numerous statutes and regulations that apply to and regulate the banking industry, many are not referenced below.

Emergency Economic Stabilization Act of 2008. On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (“EESA”), giving the US Treasury authority to take certain actions to restore liquidity and stability to the U.S. banking markets. Based upon the authority contained in the EESA, a number of programs to implement the EESA have been announced. Those programs include the following:

- Capital Purchase Program (“CPP”). Pursuant to this program, the US Treasury, on behalf of the US government, will purchase up to $250 billion of preferred stock, along with warrants to purchase common stock, from certain financial institutions, including bank holding companies, savings and loan holding companies and banks or savings associations not controlled by a holding company. On publically traded financial institutions the investment will have a dividend rate of 5% per year, until the fifth anniversary of the US Treasury’s investment and a dividend of 9% thereafter. The Company did not participate in the CCP program.

Table of Contents

- Temporary Liquidity Guarantee Program ("TLGP"). This program contains both a debt guarantee component, whereby the FDIC will guarantee until June 30, 2012, the senior unsecured debt issued by eligible financial institutions between October 14, 2008 and June 30, 2009, and an account transaction guarantee component, whereby the FDIC will insure 100% of non-interest bearing deposit transaction accounts held at eligible financial institutions, such as payment processing accounts, payroll accounts and working capital accounts, through June 30, 2010. The Banks have opted out of the debt guarantee component and opted into the transaction guarantee component of this program.

- Temporary increase in deposit insurance coverage. Pursuant to the EESA, the FDIC temporarily raised the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor, effective October 3, 2008. On January 1, 2014, the standard coverage limit will return to $100,000 for all deposit categories except Certain Retirement Accounts (includes IRAs), which will continue to be insured up to $250,000 per owner.

Given the current international, national and regional economic climate, it is unclear what effect the provisions of the EESA will have with respect to the profitability and operations of both the Company and the Banks. In addition, the US government, either through the US Treasury or some other federal agency, may also advance additional programs that could materially impact the profitability and operations of both the Company and the Banks. The failure of these governmental efforts to stabilize national and international markets could have a material effect on the Company's business, financial condition, results of operations or access to the credit markets.

US Treasury Department Report. In March 2008, the U.S. Treasury Department released a report containing short-, intermediate- and long-term recommendations to reform and modernize this country's federal financial regulatory structure. With respect to the banking industry, the report recommended the elimination of the federal thrift charter and conversion to the national bank charter, with the Office of Thrift Supervision (the "OTS") merging with and into the Office of the Comptroller of the Currency (the "OCC"), the federal agency that regulates national banks. On a longer term basis, the report also recommended a consolidation of the current functional regulation scheme for financial institutions into three distinct regulators: a market stability regulator (the Board of Governors of the Federal Reserve System); a prudent financial regulator (new); and a business conduct regulator (new). It is unclear whether and to what extent this proposal will be implemented in the future and the impact it will have upon the operations of both the Company and the Banks.

USA Patriot Act. The USA Patriot Act was enacted in 2001 which, together with regulations issued pursuant to this act, substantially broadened previously existing anti-money laundering laws and regulations, increased compliance, due diligence and reporting obligations for financial institutions, created new crimes and penalties and required federal banking agencies, in reviewing mergers and other acquisition transactions, to consider the effectiveness of the parties in combating money laundering activities. The act requires all financial institutions to establish certain anti-money laundering compliance and due diligence programs that are reasonably designed to detect and report instances of money laundering. The Company believes its compliance policies, procedures and controls satisfy the material requirements of the Patriot Act and regulations.

Table of Contents

Sarbanes-Oxley Act. The Sarbanes-Oxley Act was enacted in 2002 to, among other things, increase corporate responsibility and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the federal securities laws. This act generally applies to all companies that are required to file periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934. The act implements significant changes in the responsibilities of officers and directors of public companies and makes certain changes to the corporate reporting obligation of those companies and their external auditors. Among the requirements and prohibitions addressed by the act are certifications required by CEOs and CFOs of periodic reports filed with the SEC; accelerated reporting of stock transactions by directors, officers and large shareholders; prohibitions against personal loans from companies to directors and executive officers (except loans made in the ordinary course of business); requirements for public companies' audit committees; requirements for auditor independence; the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and executive officers in the 12-month period following initial publication of any financial statements that later require restatement; various increased criminal penalties for violations of securities laws; and the creation of a public company accounting oversight board. Rules adopted by the SEC to implement various provisions of the act include CEO and CFO certifications related to fair presentation of financial statements and financial information in public filings, as well as management's evaluation of disclosure controls and procedures; disclosure of whether any audit committee members qualify as a "financial expert"; disclosures related to audit committee composition and auditor pre-approval policies; disclosure related to adoption of a written code of ethics; reconciling non-GAAP financial information with GAAP in public communications; disclosure of off-balance sheet transactions; and disclosure related to director independence and the director nomination process. The Company has adopted modifications to its corporate governance procedures to comply with the provisions of the act and regulations.

The Company and the Banks are subject to extensive federal and state regulation and supervision. Regulation and supervision of financial institutions is primarily intended to protect depositors and the FDIC rather than shareholders of the Company. The laws and regulations affecting banks and bank holding companies have changed significantly over recent years, particularly with the passage of the Financial Services Modernization Act. There is reason to expect that similar changes will continue in the future. Any change in applicable laws, regulations or regulatory policies may have a material effect on the business, operations and prospects of the Company. The Company is unable to predict the nature or the extent of the effects on its business and earnings that any fiscal or monetary policies or new federal or state legislation may have in the future.

The Company

The Company is a bank holding company by virtue of its ownership of the Banks, and is registered as such with the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Company is subject to regulation under the Bank Holding Company Act of 1956, as amended (the "BHCA"), which subjects the Company and the Banks to supervision and examination by the Federal Reserve. Under the BHCA, the Company files with the Federal Reserve annual reports of its operations and such additional information as the Federal Reserve may require.

Table of Contents

Source of Strength to the Banks. The Federal Reserve takes the position that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, it is the Federal Reserve's position that in serving as a source of strength to its subsidiary banks, bank holding companies should use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity. It should also maintain the financial flexibility and capital raising capacity to obtain additional resources for providing assistance to its subsidiary banks. A bank holding company's failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both.

Federal Reserve Approval. Bank holding companies must obtain the approval of the Federal Reserve before they: (i) acquire direct or indirect ownership or control of any voting stock of any bank if, after such acquisition, they would own or control, directly or indirectly, more than 5% of the voting stock of such bank; (ii) merge or consolidate with another bank holding company; or (iii) acquire substantially all of the assets of any additional banks.

Non-Banking Activities. With certain exceptions, the BHCA also prohibits bank holding companies from acquiring direct or indirect ownership or control of voting stock in any company other than a bank or a bank holding company unless the Federal Reserve finds the company's business to be incidental to the business of banking. When making this determination, the Federal Reserve in part considers whether allowing a bank holding company to engage in those activities would offer advantages to the public that would outweigh possible adverse effects. A bank holding company may engage in permissible non-banking activities on a de novo basis, if the holding company meets certain criteria and notifies the Federal Reserve within ten (10) business days after the activity has commenced.

Under the Financial Services Modernization Act, eligible bank holding companies may elect (with the approval of the Federal Reserve) to become a "financial holding company." Financial holding companies are permitted to engage in certain financial activities through affiliates that had previously been prohibited activities for bank holding companies. Such financial activities include securities and insurance underwriting and merchant banking. At this time, the Company has not elected to become a financial holding company, but may choose to do so at some time in the future.

Control Transactions. The Change in Bank Control Act of 1978, as amended, requires a person or group of persons acquiring "control" of a bank holding company to provide the Federal Reserve with at least 60 days prior written notice of the proposed acquisition. Following receipt of this notice, the Federal Reserve has 60 days to issue a notice disapproving the proposed acquisition, but the Federal Reserve may extend this time period for up to another 30 days. An acquisition may be completed before the disapproval period expires if the Federal Reserve issues written notice of its intent not to disapprove the action. Under a rebuttable presumption established by the Federal Reserve, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Securities Exchange Act of 1934, as amended, would constitute the acquisition of control. In addition, any "company" would be required to obtain the approval of the Federal Reserve under the BHCA before acquiring 25% (or 5% if the "company" is a bank holding company) or more of the outstanding shares of the Company, or otherwise obtain control over the Company.

Table of Contents

Affiliate Transactions. The Company and the Banks are deemed affiliates within the meaning of the Federal Reserve Act, and transactions between affiliates are subject to certain restrictions. Generally, the Federal Reserve Act: (i) limits the extent to which the financial institution or its subsidiaries may engage in "covered transactions" with an affiliate; and (ii) requires all transactions with an affiliate, whether or not "covered transactions," to be on terms substantially the same, or at least as favorable to the institution or subsidiary, as those provided to a non-affiliate. The term "covered transaction" includes the making of loans, purchase of assets, issuance of a guarantee and similar transactions.

State Law on Acquisitions. Iowa law permits bank holding companies to make acquisitions throughout the state. However, Iowa currently has a deposit concentration limit of 15% on the amount of deposits in the state that any one banking organization can control and continue to acquire banks or bank deposits (by acquisitions), which applies to all depository institutions doing business in Iowa.

Banking Subsidiaries

Applicable federal and state statutes and regulations governing a bank's operations relate, among other matters, to capital adequacy requirements, required reserves against deposits, investments, loans, legal lending limits, certain interest rates payable, mergers and consolidations, borrowings, issuance of securities, payment of dividends, establishment of branches and dealings with affiliated persons.

First National and United Bank are national banks subject to primary federal regulation and supervision by the OCC. The FDIC, as an insurer of the deposits, also has some limited regulatory authority over First National and United Bank. State Bank, Boone Bank and Randall-Story Bank are state banks subject to regulation and supervision by the Iowa Division of Banking. The three state Banks are also subject to regulation and examination by the FDIC, which insures their respective deposits to the maximum extent permitted by law. The federal laws that apply to the Banks regulate, among other things, the scope of their business, their investments, their reserves against deposits, the timing of the availability of deposited funds and the nature and amount of and collateral for loans. The laws and regulations governing the Banks generally have been promulgated to protect depositors and the deposit insurance fund of the FDIC and not to protect stockholders of such institutions or their holding companies.

The OCC and FDIC each have authority to prohibit banks under their supervision from engaging in what it considers to be an unsafe and unsound practice in conducting their business. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") requires federal banking regulators to adopt regulations or guidelines in a number of areas to ensure bank safety and soundness, including internal controls, credit underwriting, asset growth, management compensation, ratios of classified assets to capital and earnings. FDICIA also contains provisions which are intended to change independent auditing requirements, restrict the activities of state-chartered insured banks, amend various consumer banking laws, limit the ability of "undercapitalized banks" to borrow from the Federal Reserve's discount window, require regulators to perform periodic on-site bank examinations and set standards for real estate lending.

Borrowing Limitations. Each of the Banks is subject to limitations on the aggregate amount of loans that it can make to any one borrower, including related entities. Subject to numerous exceptions based on the type of loans and collateral, applicable statutes and regulations generally limit loans to one borrower of 15% of total equity and reserves. Each of the Banks is in compliance with applicable loans to one borrower requirements.

Table of Contents

FDIC Insurance. The FDIC temporarily raised the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor, effective October 3, 2008. On January 1, 2014, the standard coverage limit will return to $100,000 for all deposit categories except certain retirement accounts (includes IRAs), which will continue to be insured up to $250,000. Generally, under the permanent FDIC limits, customer deposit accounts in banks are insured by the FDIC for up to a maximum amount of $100,000 for single accounts, $250,000 for self-directed retirement accounts, $100,000 for joint accounts, and $100,000 for qualifying revocable trust accounts. The FDIC has adopted a risk-based insurance assessment system under which depository institutions contribute funds to the FDIC insurance fund based on their risk classification. The FDIC may terminate the deposit insurance of any insured depository institution if it determines after an administrative hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law. On September 29, 2009, the FDIC developed a restoration plan to replenish the Deposit Insurance Fund over a period of eight years and to increase the deposit insurance reserve ratio to the statutory minimum of 1.15% of insured deposits. To ensure that the reserve ratio returns to 1.15 percent within the statutorily mandated period of time, to meet the FDIC's liquidity needs without imposing additional burdens on the industry during a period of stress, and to ensure that the deposit insurance system remains directly industry-funded, the FDIC staff recommends that the Board: (1)Impose no further special assessments under the final rule adopted in May 2009; (2)Maintain assessment rates at their current levels through the end of 2010 and thereafter adopt a uniform 3 basis point increase in assessment rates effective January 1, 2011; (3)Extend the Amended Restoration Plan to eight years; and (4)Require all institutions to prepay, on December 30, 2009, their estimated risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012, at the same time that institutions pay their regular quarterly deposit insurance assessments for the third quarter of 2009. An institution would initially account for the prepaid assessments as a prepaid expense (an asset); the Fund would initially account for the amount collected as both an asset (cash) and an offsetting liability (deferred revenue). An institution's quarterly risk-based deposit insurance assessment thereafter would be offset by the amount prepaid until that amount is exhausted or until December 30, 2014, when any amount remaining would be returned to the institution. FDIC staff estimates that total prepaid assessments would amount to approximately $45 billion.

Capital Adequacy Requirements. The Federal Reserve, the FDIC and the OCC (collectively, the "Agencies") have adopted risk-based capital guidelines for banks and bank holding companies that are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and account for off-balance sheet items. Failure to achieve and maintain adequate capital levels may give rise to supervisory action through the issuance of a capital directive to ensure the maintenance of required capital levels. Each of the Banks is in compliance with applicable risk-based capital level requirements as of December 31, 2009.

The current guidelines require all federally regulated banks to maintain a minimum risk-based total capital ratio equal to 8%, of which at least 4% must be Tier 1 capital. Tier 1 capital includes common shareholders' equity, qualifying perpetual preferred stock and minority interests in equity accounts of consolidated subsidiaries, but excludes goodwill and most other intangibles and the allowance for loan and lease losses. Tier 2 capital includes the excess of any preferred stock not included in Tier 1 capital, mandatory convertible securities, hybrid capital instruments, subordinated debt and intermediate term preferred stock, 45% of unrealized gain of equity securities and general reserve for loan and lease losses up to 1.25% of risk weighted assets.

Table of Contents

Under these guidelines, banks' assets are given risk weights of 0%, 20%, 50% or 100%. Most loans are assigned to the 100% risk category, except for first mortgage loans fully secured by residential property and, under certain circumstances, residential construction loans (both carry a 50% rating). Most investment securities are assigned to the 20% category, except for municipal or state revenue bonds (which have a 50% rating) and direct obligations of or obligations guaranteed by the United States Treasury or United States Government Agencies (which have a 0% rating).

The Agencies have also implemented a leverage ratio, which is equal to Tier 1 capital as a percentage of average total assets less intangibles, to be used as a supplement to the risk based guidelines. The principal objective of the leverage ratio is to limit the maximum degree to which a bank may leverage its equity capital base. The minimum required leverage ratio for top rated institutions is 3%, but most institutions are required to maintain an additional cushion of at least 100 to 200 basis points. Any institution operating at or near the 3% level is expected to be a strong banking organization without any supervisory, financial or operational weaknesses or deficiencies. Any institutions experiencing or anticipating significant growth would be expected to maintain capital ratios, including tangible capital positions, well above the minimum levels.

Prompt Corrective Action. Regulations adopted by the Agencies impose even more stringent capital requirements. The FDIC and other Agencies must take certain "prompt corrective action" when a bank fails to meet capital requirements. The regulations establish and define five capital levels: (i) "well-capitalized," (ii) "adequately capitalized," (iii) "undercapitalized," (iv) "significantly undercapitalized" and (v) "critically undercapitalized." Increasingly severe restrictions are imposed on the payment of dividends and management fees, asset growth and other aspects of the operations of institutions that fall below the category of being "adequately capitalized". Undercapitalized institutions are required to develop and implement capital plans acceptable to the appropriate federal regulatory agency. Such plans must require that any company that controls the undercapitalized institution must provide certain guarantees that the institution will comply with the plan until it is adequately capitalized. As of December 31, 2009 each of the Banks was categorized as “well capitalized” under regulatory prompt corrective action provisions.

Restrictions on Dividends. The dividends paid to the Company by the Banks are the major source of Company cash flow. Various federal and state statutory provisions limit the amount of dividends banking subsidiaries are permitted to pay to their holding companies without regulatory approval. Federal Reserve policy further limits the circumstances under which bank holding companies may declare dividends. For example, a bank holding company should not continue its existing rate of cash dividends on its common stock unless its net income is sufficient to fully fund each dividend and its prospective rate of earnings retention appears consistent with its capital needs, asset quality and overall financial condition. In addition, the Federal Reserve and the FDIC have issued policy statements which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings. Federal and state banking regulators may also restrict the payment of dividends by order.

Table of Contents

First National Bank, as a national bank, generally may pay dividends, without obtaining the express approval of the OCC, in an amount up to its retained net profits for the preceding two calendar years plus retained net profits up to the date of any dividend declaration in the current calendar year. Retained net profits as defined by the OCC, consists of net income less dividends declared during the period. On March 16, 2009, the OCC informed the Company's lead bank, First National, of the OCC's decision to establish individual minimum capital ratios for First National in excess of the capital ratios that would otherwise be imposed under applicable regulatory standards. The OCC is requiring First National to maintain, on an ongoing basis, Tier 1 Leverage Capital of 9% of Adjusted Total Assets and Total Risk Based Capital of 11% of Risk-Weighted Assets. As of December 31, 2009, First National exceeded these requirements. These capital ratios for First National may affect the amount of dividends that First National has the ability to pay. Boone Bank, Randall-Story Bank and State Bank are also restricted under Iowa law to paying dividends only out of their undivided profits. Additionally, the payment of dividends by the Banks is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and the Banks generally are prohibited from paying any dividends if, following payment thereof, the Bank would be undercapitalized.

Reserves Against Deposits. The Federal Reserve requires all depository institutions to maintain reserves against their transaction accounts (primarily checking accounts) and non-personal time deposits. Generally, reserves of 3% must be maintained against total transaction accounts of $55,200,000 or less (subject to an exemption not in excess of the first $10,700,000 of transaction accounts). A reserve of $1,656,000 plus 10% of amounts in excess of $55,200,000 must be maintained in the event total transaction accounts exceed $55,200,000. The balances maintained to meet the reserve requirements imposed by the Federal Reserve may be used to satisfy applicable liquidity requirements. Because required reserves must be maintained in the form of vault cash or a noninterest bearing account at a Federal Reserve Bank, the effect of this reserve requirement is to reduce the earning assets of the Banks.

Regulatory Enforcement Authority

The enforcement powers available to federal and state banking regulators are substantial and include, among other things, the ability to assess civil monetary penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties. In general, enforcement actions must be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions, or inactions, may provide the basis for enforcement action, including misleading or untimely reports filed with regulatory authorities. Applicable law also requires public disclosure of final enforcement actions by the federal banking agencies.

National Monetary Policies

In addition to being affected by general economic conditions, the earnings and growth of the Banks are affected by the regulatory authorities' policies, including the Federal Reserve. An important function of the Federal Reserve is to regulate the money supply, credit conditions and interest rates. Among the instruments used to implement these objectives are open market operations in U.S. Government securities, changes in reserve requirements against bank deposits and the Federal Reserve Discount Rate, which is the rate, charged member banks to borrow from the Federal Reserve Bank. These instruments are used in varying combinations to influence overall growth and distribution of credit, bank loans, investments and deposits, and their use may also affect interest rates charged on loans or paid on deposits.

Table of Contents

The monetary policies of the Federal Reserve have had a material impact on the operating results of commercial banks in the past and are expected to have a similar impact in the future. Also important in terms of effect on banks are controls on interest rates paid by banks on deposits and types of deposits that may be offered by banks. The Depository Institutions Deregulation Committee, created by Congress in 1980, phased out ceilings on the rate of interest that may be paid on deposits by commercial banks and savings and loan associations, with the result that the differentials between the maximum rates banks and savings and loans can pay on deposit accounts have been eliminated. The effect of deregulation of deposit interest rates has been to increase banks' cost of funds and to make banks more sensitive to fluctuation in market rates.

Availability of Information on Company Website

The Company files periodic reports with the Securities and Exchange Commission (“SEC”), including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. The Company makes available on or through its website free of charge all periodic reports filed by the Company with the SEC, including any amendments to such reports, as soon as reasonably practicable after such reports have been electronically filed with the SEC. The address of the Company’s website on the Internet is: www.amesnational.com.

The Company will provide a paper copy of these reports free of charge upon written or telephonic request directed to John P. Nelson, Vice President and Secretary, 405 Fifth Street, Ames, Iowa 50010 or (515) 232-6251 or by email request at info@amesnational.com. The information found on the Company’s website is not part of this or any other report the Company files with the SEC.

Table of Contents

Executive Officers of Company and Banks

The following table sets forth summary information about the executive officers of the Company and certain executive officers of the Banks. Unless otherwise indicated, each executive officer has served in his current position for the past five years.

Name	Age	Position with the Company or Bank and Principal Occupation and Employment During the Past Five Years
Kathy L. Baker	63	Named President and Director of United Bank on January 1, 2008. Previously served as a Vice President in the lending department of United Bank.
Scott T. Bauer	47	Named President of First National in 2007. Previously served as Executive Vice President and Senior Vice President of First National. Also serves as Director of First National.
Kevin G. Deardorff	55	Vice President & Technology Director of the Company.
Daniel L. Krieger	73	Chairman of the Company since 2003 and President of Company from 1997 to 2007. Also serves as a Director of the Company, Chairman of the Board and Trust Officer of First National and Chairman of the Board of Boone Bank. Previously served as President of First National and Chairman of the Board of United Bank.
Stephen C. McGill	55	President of State Bank since 2003. Previously served as Senior Vice President of State Bank. Director of State Bank.
John P. Nelson	43	Vice President, Secretary and Treasurer of Company. Also serves as Director of Randall-Story Bank.
Thomas H. Pohlman	59	Named President of the Company in 2007. Previously served as Chief Operating Officer of the Company in 2006 and President of First National from 1999 to 2007. Director of the Company and First National, State Bank and United Bank.
Jeffrey K. Putzier	48	President of Boone Bank since 1999. Director of Boone Bank.
Richard J. Schreier	42	Named President of Randall-Story in May, 2008. Also serves as a director at Randall-Story. Previously served as Senior Vice President of lending at Randall-Story and State Bank.
Terrill L. Wycoff	66	Executive Vice President of First National since 2000. Director of First National.

Table of Contents

ITEM 1A. RISK FACTORS

Set forth below is a description of risk factors related to the Company's business, provided to enable investors to assess, and be appropriately apprised of, certain risks and uncertainties the Company faces in conducting its business. An investor should carefully consider the risks described below and elsewhere in this Report, which could materially and adversely affect the Company's business, results of operations or financial condition. The risks and uncertainties discussed below are also applicable to forward-looking statements contained in this Report and in other reports filed by the Company with the Securities and Exchange Commission. Given these risks and uncertainties, investors are cautioned not to place undue reliance on forward-looking statements.

General Business, Economic and Political Conditions.

The Company's earnings and financial condition are affected by general business, economic and political conditions. For example, a depressed economic environment increases the likelihood of lower employment levels and recession, which could adversely affect the Company's earnings and financial condition. General business and economic conditions that could affect the Company include short-term and long-term interest rates, inflation, fluctuations in both debt and equity capital markets and the strength of the national and local economies in which the Company operates. Political conditions can also affect the Company's earnings through the introduction of new regulatory schemes and changes in tax laws.

In particular, the latter half of 2007 through 2009 saw many negative developments in the financial services industry which have caused significant uncertainty and volatility in the financial markets in general. Additionally, the severe economic downturn that began in the fourth quarter of 2008 has continued into 2010 and, although a gradual recovery appears underway, there remains significant economic uncertainty that could continue to undermine business and commercial activity on a global basis. As a consequence of this recession, a wide range of industries continue to face serious challenges, related in part to reduced consumer confidence.

The current economic downturn has caused many lending institutions to experience declines in the performance of their loans. The values of real estate collateral supporting mortgage loans have declined and may continue to do so, providing less security for those loans. Across the industry, bank holding companies and bank stock prices have been volatile, as has the ability of banks to raise capital and borrow. Because of the uncertainty and upheaval within the financial markets and industry, there is a potential for new federal and/or state laws and regulations regarding lending, funding and liquidity practices of banks. Proposals for significant regulatory reform of financial institutions are currently pending in Congress. Any new legislation or regulations could negatively impact the Company's operations.

In addition, further negative market developments may continue to undermine consumer confidence levels and cause adverse changes in payment patterns, causing an increase in delinquencies and default rates, which in turn may impact the Company's charge-offs and provisions for loan losses. A worsening of these market conditions could exacerbate their already adverse effect on the Company and the Banks and others in the financial services industry.

Table of Contents

Individual Minimum Capital Ratios

In March of 2009, the OCC imposed individual minimum capital ratios requiring First National to maintain, on an ongoing basis, Tier One Leverage Capital of 9% of Adjusted Total Assets and Total Risk Based Capital of 11% of Risk Weighted Assets. As of December 31, 2009, First National exceeded these capital ratios. Failure to maintain the individual minimum capital ratios could result in additional regulatory action against First National.

Risks Associated with Loans

A significant source of risk for the Company arises from the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. The Company has underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for loan losses, that management believes are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan performance and diversifying the Company's loan portfolio. Such policies and procedures, however, may not prevent unexpected losses that could adversely affect results of operations. During 2009, the Company's allowance for loan losses and its level of impaired loans increased by $872,000 and $3,677,000, respectively, over 2008 figures, and these amounts may continue to increase during 2010 as the economic downturn continues to adversely impact the Company's borrowers.

Bank regulatory agencies periodically review the Company's allowance for loan losses and may require an increase in the provision for loan losses, an increase in loans considered to be "impaired" or the recognition of further loan charge-offs, based on current economic conditions. Any increases in the allowance for loan losses will result in a decrease in net income and capital and may have a material adverse effect on the Company's financial condition, results of operations and cash flows.

The Company makes various assumptions and judgments about the collectability of the Company's loan portfolio, including the creditworthiness of the Company's borrowers and the value of the real estate and other assets serving as collateral for the repayment of the Company's loans. Despite the Company's underwriting and monitoring practices, the Company's loan customers may not repay their loans according to their terms, and the collateral securing the payment of these loans may be insufficient to pay any remaining loan balance. The Company may experience significant loan losses, which could have a material adverse effect on its operating results. Because the Company must use assumptions regarding individual loans and the economy, the current allowance for loan losses may not be sufficient to cover actual loan losses, and increases in the allowance may be necessary. The Company may need to significantly increase the Company's provision for losses on loans if one or more of the Company's larger credit relationships becomes delinquent. Material additions to the Company's allowance would materially decrease the Company's net income. The Company cannot provide any assurance that its monitoring procedures and policies will reduce certain lending risks or that the Company's allowance for loan losses will be adequate to cover actual losses.

Equity Securities

In 2009, the Company did not have realized net gains in the Company's equity securities as the Company has had in the past. The Company's equity securities portfolio has been reduced to $4.3 million as of December 31, 2009 (on an unconsolidated basis, excluding Bank holdings) in part to reduce the Company's exposure to the market's volatility, which may result in limited equity securities gains in 2010 as compared to past years. The Company invests capital that may be utilized for future expansion in a portfolio of primarily financial and utility stocks. The Company focuses on stocks that have historically paid dividends in an effort to lessen the negative effects of a bear market. The strategy, however, did not prove successful in 2009 as problems in the residential mortgage industry caused a significant decline in the market value of the Company's equity securities. Unrealized losses in the Company's equity portfolio totaled $1.3 million and $1.0 million (at the holding company level on an unconsolidated basis) as of

December 31, 2009 and 2008, respectively. Realized losses were $47,000 during 2009, as compared realized gains of $3.2 million during 2008. In addition, the Company recognized no impairment losses in the equity portfolio in 2009 and $8.5 million in 2008. The losses in 2008 were in connection with the impairment of Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) preferred stock. It is possible that the Company may incur impairment losses in 2010 which would have a negative impact on the Company's earnings for the year.

Table of Contents

Debt Securities

A substandard performance in the Company's debt securities portfolio could negatively impact the Company's earnings. The Company has invested in state and political subdivisions, U.S. government mortgage-backed securities, corporate bonds, U.S. government agencies and U.S. treasuries. The Company incurred impairment losses of approximately $30,000 and $3.6 million in its debt securities portfolio during 2009 and 2008, respectively, and it is possible that the Company may incur impairment losses on its debt securities during 2010 if economic conditions continue to deteriorate and adversely impact the issuers of the Company's debt securities. Any impairment losses on debt securities would have a negative impact on the Company's earnings for the year.

Other Real Estate Owned

"Other real estate owned" consists of real estate collateral that the Company has received in foreclosure, or accepted in lieu of foreclosure, of impaired loans. The value of the Company's holdings of other real estate owned decreased to $10.5 million as of December 31, 2009 from $13.3 million as of December 31, 2008, primarily due to the impairment write downs and sales of other real estate owned, offset in part by foreclosures. Management obtains independent appraisals or performs evaluations to determine that these properties are carried at the lower of the new costs basis or fair value less cost to sell. These independent appraisals or evaluations are performed periodically by management with respect to current and any future other real estate owned, and any subsequent write-downs will be recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell. Due to potential changes in economic conditions, it is 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.

Rising Interest Rates

An increase in interest rates that may occur in connection with the recovery of the economy could 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 its 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.

Liquidity Risk

Table of Contents

Maintaining adequate liquidity is essential to the banking business. An inability to raise funds through deposits, borrowing, sale of securities or other sources could have a substantial negative impact on the Company’s liquidity. Access to funding sources in amounts necessary to finance the Company’s activities or with terms that are acceptable to the Company could be impaired by factors that affect the Company specifically or the financial services industry or economy in general. Factors that could detrimentally impact the Company’s access to liquidity sources include a decrease in the level of the Company’s business activity as a result of a downturn in the markets or adverse regulatory action against the Company. The Company’s ability to borrow could be impaired by factors such as a disruption in the financial markets or negative views and expectations of the prospects for the financial services industry in light of the recent turmoil facing the industry.

Although the Company’s current sources of funds are adequate for its liquidity needs, there can be no assurance in this regard for the future. If additional debt is needed in the future, there can be no assurance that such debt would be available or, if available, would be on favorable terms. The ability of banks and holding companies to raise capital or borrow in the debt markets may be affected by recent economic conditions. If additional financing sources are unavailable or not available on reasonable terms, the Company’s financial condition, results of operations and future prospects could be adversely affected.

Customer Concern over Deposit Insurance

With recent increased concerns about bank failures, customers are concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits in an effort to ensure that the amount they have on deposit with their bank is fully insured. Decreases in deposits, if they were to occur, could adversely affect the Company’s funding costs and net income.

Increase in Deposit Insurance Premium

On September 29, 2009, the FDIC developed a restoration plan to replenish the Deposit Insurance Fund over a period of eight years and to increase the deposit insurance reserve ratio to the statutory minimum of 1.15% of insured deposits. To ensure that the reserve ratio returns to 1.15 percent within the statutorily mandated period of time, to meet the FDIC’s liquidity needs without imposing additional burdens on the industry during a period of stress, and to ensure that the deposit insurance system remains directly industry-funded, FDIC staff recommends that the Board: (1) Impose no further special assessments under the final rule adopted in May 2009; (2) Maintain assessment rates at their current levels through the end of 2010 and thereafter adopt a uniform 3 basis point increase in assessment rates effective January 1, 2011; (3) Extend the Amended Restoration Plan to eight years; and (4) Require all institutions to prepay, on December 30, 2009, their estimated risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012, at the same time that institutions pay their regular quarterly deposit insurance assessments for the third quarter of 2009. An institution would initially account for the prepaid assessments as a prepaid expense (an asset); the Fund would initially account for the amount collected as both an asset (cash) and an offsetting liability (deferred revenue). An institution’s quarterly risk-based deposit insurance assessment thereafter would be offset by the amount prepaid until that amount is exhausted or until December 30, 2014, when any amount remaining would be returned to the institution. FDIC staff estimate that total prepaid assessments would amount to approximately $45 billion. Any increase in the risk category of the Banks or any increase in the base assessment rates, or the imposition of any special assessments, would likely have a material adverse effect on the Company’s earnings.

Table of Contents

Concentration of Operations

The Company's operations are concentrated in central Iowa. As a result of this geographic concentration, the Company's results may correlate to the economic conditions in this area, which were adversely impacted by the general decline in economic and market activity experienced during 2009 and 2008. Continuing deterioration in economic conditions, particularly in the industries on which this area depends (including agriculture which, in turn, is dependent upon weather conditions and government support programs), may adversely affect the quality of the Company's loan portfolio and the demand for the Company's products and services, and accordingly, its financial condition and results of operations.

Competition with Larger Financial Institutions

The banking and financial services business in the Company's market area continues to be a competitive field and is becoming more competitive as a result of:

- changes in regulations;
- changes in technology and product delivery systems; and
- the accelerating pace of consolidation among financial services providers.

It may be difficult to compete effectively in the Company's market, and results of operations could be adversely affected by the nature or pace of change in competition. The Company competes for loans, deposits and customers with various bank and non-bank financial services providers, many of which are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services.

Trading Volume

The trading volume in the Company's common stock on the Nasdaq Capital Market is relatively limited compared to those of larger companies listed on the Nasdaq Capital Market, the Nasdaq Global Markets, the New York Stock Exchange or other consolidated reporting systems or stock exchanges. A change in the supply or demand for the Company's common stock may have a more significant impact on the price of the Company's stock than for more actively traded companies.

Technological Advances

The financial services industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to improving customer services, the effective use of technology increases efficiency and enables financial institutions to reduce costs. The Company's future success will depend, in part, on its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands for convenience, as well as to create additional efficiencies in the Company's operations. Many of our competitors have substantially greater resources than the Company to invest in technological improvements.

Table of Contents

Government Regulations

Current and future legislation and the policies established by federal and state regulatory authorities will affect the Company’s operations. The Company and its Banks are subject to extensive supervision of, and examination by, federal and state regulatory authorities which may limit the Company’s growth and the return to our shareholders by restricting certain activities, such as:

- the payment of dividends to the Company’s shareholders;
- the payment of dividends to the Company from the Banks;
- possible mergers with or acquisitions of or by other institutions;
- investment policies;
- loans and interest rates on loans;
- interest rates paid on deposits;
- expansion of branch offices; and/or
- the possibility to provide or expand securities or trust services.

The Company cannot predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that any changes may have on future business and earnings prospects. The cost of compliance with regulatory requirements may adversely affect the Company’s net income.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Company's office is housed in the main office of First National located at 405 Fifth Street, Ames, Iowa and occupies approximately 3,357 square feet. A lease agreement between the Company and First National provides the Company will make available for use by First National an equal amount of interior space at the Company’s building located at 2330 Lincoln Way, Ames, Iowa in lieu of rental payments. The main office is owned by First National consists of approximately 45,000 square feet and includes a drive-through banking facility. In addition to its main office, First National conducts its business through two full-service offices, the University office and the North Grand office, and one super-market location, the Cub Food office. A full-service office opened in April of 2007 in Ankeny, Iowa and occupies approximately 14,000 square feet. The University office is located in a 16,000 square foot multi-tenant property owned by the Company. A 24-year lease agreement with the Company has been modified in 2002 to provide that an equal amount of interior space will be made available to the Company at First National’s main office at 405 Fifth Street in lieu of rental payments. First National will continue to rent the drive-up facilities of approximately 1,850 square feet at this location for $1,200 per month. The Cub Foods office is leased by First National under a one year lease with a one year renewal option. The current annual rental payment is $19,000. All of the properties owned by the Company and First National are free of any mortgages.

25

Table of Contents

State Bank conducts its business from its main office located at 1025 Sixth Street, Nevada, Iowa and from two additional full-service offices located in McCallsburg and Colo, Iowa. All of these properties are owned by State Bank free of any mortgage.

Boone Bank conducts its business from its main office located at 716 Eighth Street, Boone, Iowa and from one additional full-service office also located in Boone, Iowa. All properties are owned by Boone Bank free of any mortgage.

Randall-Story Bank conducts its business from its main office located at 606 Broad Street, Story City, Iowa which is owned by Randall-Story Bank free of any mortgage.

United Bank conducts its business from its main office located at 2101 South Center Street, Marshalltown, Iowa. The 5,200 square foot premise was constructed in 2002. In 2005, United Bank purchased an office location at 29 S. Center Street in Marshalltown that is 1,972 square feet. In 2007, United Bank purchased a commercial building located at 10 Westwood Drive, in Marshalltown that is 2,304 square feet for future expansion. All properties are owned by United Bank free of any mortgage.

The property the Company owns is located at 2330 Lincoln Way, Ames, Iowa consisting of a multi tenant building of approximately 16,000 square feet. First National leases 5,947 square feet of this building to serve as its University Office and remaining rentable space is leased to six tenants for business purposes. The Company owns a real estate property adjacent to 2330 Lincoln Way at 2318 Lincoln Way which consists of a single story commercial building with 2,400 square feet of leased space that is currently leased by one tenant for business purposes.

ITEM 3. LEGAL PROCEEDINGS

The Banks are from time to time parties to various legal actions arising in the normal course of business. The Company believes that there is no threatened or pending proceeding against the Company or the Banks, which, if determined adversely, would have a material adverse effect on the business or financial condition of the Company or the Banks.

ITEM 4. RESERVED

Table of Contents

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

On February 26, 2010, the Company had approximately 507 shareholders of record and an estimated 940 additional beneficial owners whose shares were held in nominee titles through brokerage or other accounts. The Company's common stock is traded on the NASDAQ Capital Market under the symbol "ATLO". Trading in the Company's common stock is, however, relatively limited.

Based on information provided to and gathered by the Company on an informal basis, the Company believes that the high and low sales price for the common stock on a per share basis during the last two years is as follows:

Quarter	2009 Market Price High	Low	Quarter	2008 Market Price High	Low
1st	$ 28.79	$ 14.87	1st	$ 20.95	$ 18.26
2nd	$ 27.00	$ 16.68	2nd	$ 22.94	$ 15.12
3rd	$ 27.00	$ 22.21	3rd	$ 42.11	$ 15.60
4th	$ 25.00	$ 18.50	4th	$ 26.98	$ 20.58

The Company declared aggregate annual cash dividends in 2009 and 2008 of approximately $3,773,000 and $10,564,000, respectively, or $0.40 per share in 2009 and $1.12 per share in 2008. In February 2010, the Company declared a cash dividend of approximately $1,038,000 or $0.11 per share. Quarterly dividends declared during the last two years were as follows:

Quarter	2009 Cash dividends declared per share	2008 Cash dividends declared per share
1st	$ 0.10	$ 0.28
2nd	$ 0.10	$ 0.28
3rd	$ 0.10	$ 0.28
4th	$ 0.10	$ 0.28

The decision to declare any such cash dividends in the future and the amount thereof rests within the discretion of the Board of Directors of the Company and will be subject to, among other things, the future earnings, capital requirements and financial condition of the Company and certain regulatory restrictions imposed on the payment of dividends by the Banks. Such restrictions are discussed in greater detail in Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources and regulatory matters in the Notes to the Company's financial statements included herein.

The Board of Directors of the Company did not renew the previously announced stock repurchase program for 2009 and no purchases were made under the program in 2009 or 2008.

Table of Contents

The following performance graph provides information regarding cumulative, five-year total return on an indexed basis of the Company's Common Stock as compared with the NASDAQ Composite Index, the SNL Midwest OTC Bulletin Board Bank Index (“Midwest OTC Bank Index”) and the SNL NASDAQ Bank Index prepared by SNL Financial L.C. of Charlottesville, Virginia. The Midwest OTC Bank Index reflects the performance of 138 bank holding companies operating principally in the Midwest as selected by SNL Financial. The SNL NASDAQ Bank Index is comprised of 329 bank and bank holding companies listed on the NASDAQ market throughout the United States. The indexes assume the investment of $100 on December 31, 2004 in the Common Stock, the NASDAQ Composite Index, Midwest OTC Bank Index and the SNL NASDAQ Bank Index with all dividends reinvested. The Company’s stock price performance shown in the following graph is not indicative of future stock price performance.

ITEM 6. SELECTED FINANCIAL DATA

The following financial data of the Company for the five years ended December 31, 2005 through 2009 is derived from the Company's historical audited financial statements and related footnotes. The information set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operation" and the consolidated financial statements and related notes contained elsewhere in this Annual Report.

Selected Financial Data

(dollars in thousands, except per share amounts)	Year Ended December 31, 2009	2008	2007	2006	2005
STATEMENT OF INCOME DATA					
Interest income	$38,891	$45,514	$47,562	$44,296	$41,306
Interest expense	10,226	16,402	23,537	21,306	15,933
Net interest income	28,665	29,112	24,025	22,990	25,373
Provision (credit) for loan losses	1,558	1,313	(94)	(183)	331
Net interest income after provision (credit) for loan losses	27,107	27,799	24,119	23,173	25,042
Noninterest income (loss)	6,924	(3,008)	7,208	6,674	5,613
Noninterest expense	22,732	17,594	16,776	15,504	15,210
Income before provision for income tax	11,299	7,197	14,551	14,343	15,445
Provision for income tax	2,293	845	3,542	3,399	3,836
Net Income	$9,006	$6,352	$11,009	$10,944	$11,609
DIVIDENDS AND EARNINGS PER SHARE DATA					
Cash dividends declared	$3,773	$10,564	$10,183	$9,801	$9,417
Cash dividends declared per share	$0.40	$1.12	$1.08	$1.04	$1.00
Basic and diluted earnings per share	$0.95	$0.67	$1.17	$1.16	$1.23
Weighted average shares outstanding	9,432,915	9,431,393	9,427,503	9,422,402	9,415,599
BALANCE SHEET DATA					
Total assets	$915,570	$858,141	$861,591	$838,853	$819,384
Net loans	415,434	452,880	463,651	429,123	440,318
Deposits	722,164	664,795	690,119	680,356	668,342
Stockholders' equity	112,340	103,837	110,021	112,923	109,227
Equity to assets ratio	12.27 %	12.10 %	12.77 %	13.46 %	13.33 %

Table of Contents

	Year Ended December 31,				
	2009	2008	2007	2006	2005
FIVE YEAR FINANCIAL PERFORMANCE					
Net income	$9,006	$6,352	$11,009	$10,944	$11,609
Average assets	880,057	857,705	843,788	818,450	831,198
Average stockholders' equity	108,412	107,794	111,371	109,508	109,802
Return on assets (net income divided by average assets)	1.02 %	0.74 %	1.30 %	1.34 %	1.40 %
Return on equity (net income divided by average equity)	8.31 %	5.89 %	9.89 %	9.99 %	10.57 %
Net interest margin (net interest income divided by average earning assets)	3.78 %	3.94 %	3.39 %	3.29 %	3.56 %
Efficiency ratio (noninterest expense divided by noninterest income plus net interest income)	63.87 %	67.40 %	53.71 %	52.27 %	49.09 %
Dividend payout ratio (dividends per share divided by net income per share)	42.11 %	167.16 %	92.31 %	89.66 %	81.30 %
Dividend yield (dividends per share divided by closing year-end market price)	1.89 %	4.22 %	5.54 %	4.95 %	3.89 %
Equity to assets ratio (average equity divided by average assets)	12.32 %	12.57 %	13.20 %	13.38 %	13.21 %

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Ames National Corporation (Company) is a bank holding company established in 1975 that owns and operates five bank subsidiaries (Banks) in central Iowa. The following discussion is provided for the consolidated operations of the Company and its Banks: First National, State Bank, Boone Bank, Randall-Story Bank and 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 and the managing of its own bond and equity portfolio. 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, marketing, audit, compliance, technology systems and the coordination of management activities, in addition to 175 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 prompt response times and flexibility in the products and services offered. This strategy is viewed as providing an opportunity to increase revenues through the creation of a competitive advantage over other financial institutions. The Company also strives to remain operationally efficient to improve profitability while enabling the Banks 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) service charges on deposit accounts maintained at the Banks; (iii) interest on fixed income investments held by the Company and the Banks; (iv) fees on trust services provided by those Banks exercising trust powers; and (v) securities gains. 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 Banks' loan and deposit functions; (iv) occupancy expenses for maintaining the Banks' facilities; (v) FDIC insurance assessments; and (vi) other real estate owned costs. 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 deposit accounts 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.

Table of Contents

The Company reported net income of $9,006,000 for the year ended December 31, 2009 compared to $6,352,000 and $11,009,000 reported for the years ended December 31, 2008 and 2007, respectively. This represents an increase of 41.8% when comparing 2009 to 2008. The increase in net income in 2009 from 2008 was primarily the result of improved non-interest income due to the losses associated with other-than-temporary impairment of investment securities in 2008 as compared to 2009. This improvement was offset in part by higher non-interest expense associated primarily with other real estate owned and FDIC insurance assessments. The decrease in net income in 2008 from 2007 of 42.3% was the result of lower non-interest income associated with the other-than-temporary impairment of investment securities recorded in 2008. Although net interest income improved 21% in 2008 over 2007, this increase was more than offset by lower non-interest income associated with the other-than-temporary impairment of investment securities recorded in 2008. Earnings per share for 2009 were $0.95 compared to $0.67 in 2008 and $1.17 in 2007. All five Banks demonstrated profitable operations during 2009.

The Company's return on average equity for 2009 was 8.31% compared to 5.89% and 9.89% in 2008 and 2007, respectively, and the return on average assets for 2009 was 1.02% compared to 0.74% in 2008 and 1.30% in 2007. The increase in return on average equity and assets when comparing 2009 to 2008 was primarily a result of the other-than-temporary impairment on investment securities recorded in 2008, offset in part by increased costs associated with other real estate owned and FDIC insurance assessments. The decrease in return on average equity and assets when comparing 2008 to 2007 was primarily a result of the other-than-temporary impairment on investment securities recorded in 2008.

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

- Challenges
- Key Performance Indicators
- Industry Results
- Critical Accounting Policies
- Income Statement Review
- Balance Sheet Review
- Asset Quality Review and Credit Risk Management
- Liquidity and Capital Resources
- Interest Rate Risk
- Inflation
- Forward-Looking Statements

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.

- On July 16, 2008, the Company's lead bank, First National, entered into an informal Memorandum of Understanding with the Office of the Comptroller of the Currency (the "OCC") regarding First National'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 processes, problem loan management, credit risk ratings recognition and loan review procedures. Since entering into the Memorandum, management has actively pursued the corrective actions required by the Memorandum in an effort to address the deficiencies noted in administration of its commercial real estate loan portfolio. On January 14, 2010, the OCC terminated the Memorandum of Understanding.

- In March of 2009, the OCC imposed individual minimum capital ratios requiring First National to maintain, on an ongoing basis, Tier One Leverage Capital of 9% of Adjusted Total Assets and Total Risk Based Capital of 11% of Risk Weighted Assets. As of December 31, 2009, First National exceeded these capital ratios. Failure to maintain the individual minimum capital ratios could result in additional regulatory action against First National.

- The Company and the Banks have invested in various corporate bonds issued by various companies whose financial condition may further deteriorate, thus requiring additional impairment charges. Management believes that impairments in the investment portfolio at December 31, 2009 are temporary; however, it is reasonably possible that additional impairment charges may be necessary on investment securities in future periods if financial and economic conditions do not improve or deteriorate further.

- Interest rates are likely to increase as the economy continues its gradual recovery and an increasing interest rate environment may present a challenge to the Company. 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 may 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.

Table of Contents

- In 2009, the Company did not recognize net gains in the Company's equity securities as typically occurred in the past years. The Company's equity securities portfolio (excluding the Banks) has been reduced to $4.3 million as of December 31, 2009 in response to the volatility in the stock market. This reduction will likely result in limited securities gains in 2010 when compared to past years. The Company invests a portion of its' capital that may be utilized for future expansion in a portfolio of primarily financial and utility stocks. The Company focuses on stocks that have historically paid dividends in an effort to lessen the negative effects of a bear market. The strategy, however, did not prove successful in 2009 as problems due to the national recession caused a significant decline in the market value of the Company's equity securities. Unrealized losses in the Company's equity portfolio totaled $1.3 million and $1.0 million (at the holding company level on an unconsolidated basis) as of December 31, 2009 and 2008, respectively. The Company recognized losses in its equity portfolio of $47,000 during 2009, compared to realized gains of $3.2 million during 2008 (at the holding company level on an unconsolidated basis). Additionally, the Company recognized no impairment losses in the equity portfolio in 2009 and $8.5 million in 2008. The losses in 2008 were in connection with the impairment of Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) preferred stock. The Company has significantly reduced its exposure to equity securities, although it is possible that the Company may incur impairment losses in 2010 which would have a negative impact on the Company's earnings for the year.

- Loans amounted to $415.4 million and $452.9 million as of December 31, 2009 and 2008, respectively. The loan portfolio decreased 8.3% during the year ended December 31, 2009. The decline in the loan portfolio is primarily due to declines in the commercial operating and commercial real estate loan portfolios. A continued decline in the loan portfolio would have a negative impact on the Company's earnings for the year.

- The economic conditions for commercial real estate developers in the Des Moines metropolitan area deteriorated in 2009 and 2008 and significantly contributed to the Company's increased level of non-performing loans, other real estate owned and related costs. During the year ended December 31, 2009, the Company foreclosed on six real estate properties (other real estate owned) totaling $1.8 million in the Des Moines market. Presently, the Company has $4.7 million in impaired loans with four Des Moines development companies with specific reserves totaling $371,000. The Company has additional customer relationships with real estate developers in the Des Moines area that may become impaired in the future if economic conditions do not improve or become worse. The Company has a limited number of such credits and is actively engaged with the customers to minimize credit risk.

Table of Contents

- Other real estate owned amounted to $10.5 million and $13.3 million as of December 31, 2009 and 2008, respectively. Other real estate owned costs amounted to $4,198,000, $151,000 and $120,000 for the years ended December 31, 2009, 2008 and 2007, respectively. Management obtains independent appraisals or performs evaluations to determine that these properties are carried at the lower of the new cost basis or fair value less cost to sell. It is at least reasonably possible that changes in fair values will occur in the near term and that such changes could have a negative impact on the Company's earnings.

- The FDIC imposes an assessment against all depository institutions for deposit insurance. Notably, the FDIC has the authority to increase insurance assessments and has increased deposit insurance assessments in 2009. FDIC insurance assessments amounted to $1,675,000, $243,000 and $159,000 for the years ended December 31, 2009, 2008 and 2007, respectively. In 2009, 140 banks failed compared to 25 bank failures in 2008 and 3 in 2007. In 2011, the FDIC has a scheduled assessment increase for all FDIC insured institutions. An increase in FDIC deposit assessments will have a negative impact on the Company's earnings.

- The Company operates in a highly regulated environment and is subject to extensive regulation, supervision and examination. Applicable laws and regulations may change, and there is no assurance that such changes will not adversely affect the Company's business. In this respect potentially landscape-changing legislative proposals have been introduced in Congress and by regulatory agencies with respect to their respective regulatory powers. Such regulation and supervision govern the activities in which an institution may engage and are intended primarily for the protection of the Bank, its depositors and the FDIC. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including but not limited to the imposition of restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution's allowance for loan losses. Any change in such regulation and oversight, whether in the form of restrictions on activities, regulatory policy, regulations, or legislation, including but not limited to changes in the regulations governing banks, could have a material impact on the Company's operations. It is unknown at this time to what extent legislation will be passed into law or regulatory proposals will be adopted, or the effect that such passage or adoption will have on the banking industry or the Company.

Table of Contents

Key Performance Indicators

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 8,012 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

	Year Ended December 31,					
	2009		2008		2007	
	Company	Industry	Company	Industry	Company	Industry
Return on assets	1.02 %	0.09 %	0.74 %	0.12 %	1.30 %	0.81 %
Return on equity	8.31 %	0.90 %	5.89 %	1.24 %	9.89 %	7.75 %
Net interest margin	3.78 %	3.47 %	3.94 %	3.18 %	3.39 %	3.29 %
Efficiency ratio	63.87 %	55.53 %	67.40 %	59.02 %	53.71 %	59.37 %
Capital ratio	12.32 %	8.65 %	12.57 %	7.49 %	13.20 %	7.98 %

Key performance 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 return on assets ratio is higher than that of the industry, primarily as a result of the Company's higher net interest margins and lower provision for loan 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 equity ratio is higher than the industry primarily as a result the Company's higher net interest margins and lower provision for loan losses.

- Net Interest Margin

This ratio is calculated by dividing net interest income by average earning assets. Earning assets consist primarily 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 deposit accounts and other borrowings. The Company's net interest margin is higher than peer bank averages.

Table of Contents

- 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 is higher than the industry average. The Company's efficiency ratio decreased in 2009 as compared to 2008 primarily as a result of the other-than-temporary impairment in 2008.

- Capital Ratio

The 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 fourth quarter of 2009:

Fourth Quarter Earnings Are Slightly Above Break-Even

The benefits of a recovering economy and stable financial markets in year-over-year comparisons were evident in the performance of insured depository institutions in the fourth quarter. The small profit reported by the industry in the quarter essentially represented break-even performance, but it contrasted sharply with the record quarterly loss posted in the fourth quarter of 2008. Fourth quarter bank net income for the industry was $914 million, compared with a $37.8 billion net loss a year earlier. While much of the year-over-year earnings improvement was concentrated among the largest banks, there was also evidence of a broader improving trend. For the first time in three years, more than half of insured institutions reported year-over-year improvement in net income. The percentage of institutions reporting a net loss for the quarter was lower than a year ago. The average return on assets (ROA) for all four of the asset size groups featured in the Quarterly Banking Profile was better than a year ago, although only the largest size group—institutions with more than $10 billion in assets—had a positive average ROA for the quarter.

Revenues Rebound from Fourth Quarter 2008

A number of factors contributed to the year-over-year improvement in quarterly earnings. Noninterest income was $21.7 billion (53.2%) higher than in the fourth quarter of 2008, as several categories of noninterest income that were negative a year ago swung back into positive territory. Trading revenues totaled $2.8 billion in the quarter, compared with $9.2 billion in trading losses a year earlier. Servicing income also rebounded strongly, from a $390 million loss a year ago to a gain of $8.0 billion. Loan sales produced $1.3 billion in gains, versus $1.3 billion in losses in the fourth quarter of 2008. Another significant contribution to the improvement in earnings came from a $16.2 billion (14.2%) decline in noninterest expense. This decline was the result of an $18.1 billion (77.2%) reduction in charges for goodwill impairment and other intangible asset expenses. Quarterly loan-loss provisions posted a year-over-year decline for the first time since the third quarter of 2006, falling by $10.0 billion (14.1%). Provisions remained above $60 billion for the fifth consecutive quarter, but the $61.1 billion that institutions set aside in the quarter was the smallest quarterly total since the third quarter of 2008. Realized gains on securities and other assets totaled $158 million, an $8.7 billion improvement over the $8.6 billion in realized losses reported by the industry a year ago. Net interest income was higher than a year ago but only by $1.7 billion (1.8%).

Table of Contents

Margins Register Improvement

The average net interest margin (NIM) in the fourth quarter was 3.49%, slightly lower than the 3.51% reported in the third quarter but higher than the 3.33% average in the fourth quarter of 2008. The quarter-over-quarter decline was concentrated among larger institutions. More than half of all institutions (55.5%) reported higher NIMs compared to third quarter levels. Also, quarterly NIMs at a majority of institutions (53.0%) increased from a year ago, with larger institutions reporting the biggest gains. Margin improvements helped offset declines in interest-bearing assets. Earning assets declined by $138.8 billion (1.2%) during the fourth quarter and fell by $477.2 billion (4.1%) for the full year.

Full Year Earnings Remain Well below Historical Norms

Full-year 2009 net income was $12.5 billion, up from $4.5 billion in 2008, but well below the $100 billion in net income the industry reported for 2007. Increased noninterest income, higher net interest income, and lower realized losses on securities and other assets outstripped increased noninterest expenses and higher loan loss provisions to produce the increase in earnings. Noninterest income was $52.8 billion (25.4%) higher than in 2008, with trading revenue registering a $26.6 billion improvement. Net interest income was $38.1 billion (10.6%) higher, as the full-year industry NIM rose for the first time in seven years. The average NIM in 2009 was 3.47%, the highest annual average since 2005. Realized losses on securities and other assets fell from $15.4 billion in 2008 to $1.4 billion in 2009. These positive contributions to the rise in full year earnings were partially offset by a $71.5 billion (40.6%) increase in loan loss provisions and a $16.3 billion (4.4%) increase in noninterest expense. More than one in four institutions (29.5%) reported negative net income for the year, up from 24.8% in 2008. This is the highest proportion of unprofitable institutions in any year since at least 1984. The average ROA in 2009 was 0.09%, up from 0.03% in 2008. As was the case in 2008, full-year industry earnings for 2009 (which consist of calendar-year net income of 8,012 insured institutions filing December 31 financial reports) would have been significantly lower if losses experienced by institutions that failed during the year were reflected in year-end reporting.

Loan Losses Rise for Twelfth Consecutive Quarter

Asset quality indicators worsened in the fourth quarter. Net charge-offs (NCOs) totaled $53.0 billion, an increase of $14.4 billion (37.2%) over the same period in 2008. The annualized net charge-off rate rose to 2.89%, up from 1.95% a year earlier and 2.72% in the third quarter of 2009. This is the highest quarterly NCO rate reported by the industry in the 26 years for which quarterly NCO data are available. NCOs in all major loan categories increased from a year ago. The largest increases occurred in residential mortgage loans, where NCOs rose by $3.3 billion (47.7%); credit cards (up by $2.7 billion, or 41.4%); loans to commercial and industrial (C&I) borrowers (up $2.3 billion, or 37.0%); home equity loans (up $1.9 billion, or 58.6%); and real estate loans secured by nonfarm nonresidential properties (up $1.9 billion, or 130.9%). This is the 12th consecutive quarter that NCOs have posted a year-over-year increase.

Table of Contents

Growth in Noncurrent Loans Slows

Noncurrent loans and leases continued to rise through the end of the year, with a few notable exceptions. The total amount of loans and leases that were noncurrent (90 days or more past due or in nonaccrual status) increased by $24.3 billion (6.6%) in the fourth quarter, to $391.3 billion, or 5.37% of all loans and leases at year end. This is the highest level for the industry's noncurrent rate in the 26 years that all insured institutions have reported noncurrent loan data. The increase in noncurrent loans in the quarter was largely driven by noncurrent residential mortgage loans, which rose by $23.2 billion (14.9%). Much of this increase—$19.1 billion—consisted of rebooked GNMA mortgages that have government guarantees. The amount of real estate loans secured by nonfarm nonresidential real estate properties that were noncurrent rose by $4.5 billion (12.2%). In contrast, noncurrent C&I loans declined by $3.5 billion (7.7%), and noncurrent real estate construction and development (C&D) loans fell by $2.0 billion (2.7%). This was the first time in three years that noncurrent C&I loans have declined and the first time in four years that noncurrent C&D loans have fallen.

Reserves Exceed Three Percent of Total Loans

Reserves for loan and lease losses increased by only $7.0 billion (3.2%) in the fourth quarter, as institutions added $8.1 billion more in loss provisions to their reserves than they took out in net charge-offs. The average coverage ratio of reserves to noncurrent loans and leases fell from 60.1% to 58.1%, ending the year at the lowest level since midyear 1991. In contrast, the industry's ratio of reserves to total loans and leases rose from 2.97% to 3.12% during the quarter, and is now at its highest level since the creation of the FDIC. During 2009, 119 institutions filed year-to-date financial reports for one or more quarters of the year before their failure. Together, these institutions reported more than $8.2 billion in net losses through the first three quarters of 2009 that are not included in full-year earnings for the industry. These losses are reflected in the published quarterly industry earnings totals for the first three quarters of 2009. In addition, under purchase accounting rules, income and expenses that have been booked by acquired institutions are reset to zero as of the date when a change in ownership occurs; previously accrued income and expenses are reflected as adjustments to the assets, equity capital, and reserves of acquired institutions and are not included in the subsequent reporting of year-to-date income and expense.

Capital Ratios Improve

The industry's capital also registered relatively slow growth in the quarter. Bank equity increased by only $4.1 billion (0.3%), the smallest increase in the last four quarters. Leverage capital (as defined for Prompt Corrective Action purposes) increased by $11.9 billion (1.1%). Despite the slow growth in capital, the industry's regulatory capital ratios all improved, as industry assets fell.

Banks Report Further Declines in Loan Balances

Total assets of insured institutions fell for a fourth consecutive quarter, declining by $137.2 billion (1.0%). During the year, total industry assets declined by a net $731.7 billion (5.3%), the largest percentage decline in a year since the inception of the FDIC. Total loan and lease balances declined for the sixth quarter in a row, falling by $128.8 billion (1.7%). The fourth-quarter decline was led by C&I loan balances, which fell by $54.5 billion (4.3%); real estate C&D loans (down $41.5 billion, or 8.4%); loans to depository institutions (down $21.2 billion, or 15.9%); and residential mortgage loans (down $11.2 billion, or 0.6%). Credit card balances increased $29.1 billion during the quarter (7.4%), but balances in all other major loan categories declined. Insured institutions continued to add to their securities holdings. Slightly more than half of all insured institutions (52%) reported declining loan balances in the fourth quarter. Total securities increased by $103.7 billion (4.3%) during the quarter, with mortgage backed securities rising by $44.8 billion (3.3%), and U.S. Treasury securities increasing by $15.9 billion (18.3%). During 2009, insured institution securities holdings increased by $465.1 billion (22.9%).

Table of Contents

Deposit Growth Remains Strong

Institutions continued to increase their reliance on deposit funding in the fourth quarter. Even as assets were declining, total deposits increased by $125.7 billion (1.4%), as domestic noninterest-bearing deposits rose by $89.8 billion (6.1%). Nondeposit liabilities fell by $268.1 billion (10.0%) during the quarter, led by a $184.1 billion (23.3%) decline in Federal funds purchased and securities sold under repurchase agreements. Federal Home Loan Bank advances fell by $42.6 billion (7.4%). During the quarter, the percentage of industry assets funded by deposits rose from 68.7% to 70.4%, the highest level since March 31, 1996.

Industry Consolidation Continues

The number of insured commercial banks and savings institutions reporting financial results declined by 87 during the fourth quarter. Only three new charters were added during the quarter, while 43 institutions were absorbed by mergers and 45 institutions failed. For the full year, the number of reporting institutions fell from 8,305 to 8,012. Only 31 new charters were added in 2009, the smallest annual total since 1942. Mergers absorbed 179 institutions during the year, and 140 insured institutions failed. This is the largest number of bank failures in a year since 1992. The number of institutions on the FDIC’s “Problem List” rose to 702 at the end of 2009, from 552 at the end of the third quarter and 252 at the end of 2008. Total assets of “problem” institutions were $402.8 billion at year end 2009, compared with $345.9 billion at the end of September and $159.0 billion at the end of 2008. Both the number and assets of “problem” institutions are at the highest level since June 30, 1993.

Critical Accounting Policies

The discussion contained in this Item 7 and other disclosures included within this Report are based 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” accompanying the Company’s audited financial statements. Based on its consideration of accounting policies that involve the most complex and subjective estimates and judgments, management has identified the allowance for loan losses, valuation of other real estate owned and the assessment of other-than-temporary impairment for certain financial instruments to be the Company’s most critical accounting policies.

Table of Contents

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.

In December of 2006, the Office of the Comptroller of the Currency and other federal banking regulatory agencies issued in inter-agency policy statement to provide guidance to boards of directors and management concerning the process for reviewing and determining the allowance for loan losses and to ensure consistency of that process with generally accepted accounting principles. For further discussion concerning the allowance for loan losses and the process of establishing specific reserves, see the section of this Report entitled "Asset Quality Review and Credit Risk Management" and "Analysis of the Allowance for Loan Losses".

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, valuations 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 on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value. 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. Independent appraisals or evaluations are periodically performed by management; 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. These 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.

Other-Than-Temporary Impairment of Investment Securities

Declines in the fair value of available-for-sale securities 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 changes 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.

Table of Contents

Income Statement Review

The following highlights a comparative discussion of the major components of net income and their impact for the last three years.

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. Refer to the net interest income discussion following the tables for additional detail.

Table of Contents

ASSETS

	2009				2008				2007			
(dollars in thousands)	Average balance	Revenue/ expense	Yield/ rate		Average balance	Revenue/ expense	Yield/ rate		Average balance	Revenue/ expense	Yield/ rate	
Interest-earning assets												
Loans 1												
Commercial	$68,677	$3,536	5.15	%	$82,448	$4,915	5.96	%	$78,241	$6,201	7.93	%
Agricultural	36,351	2,196	6.04	%	32,230	2,227	6.91	%	31,964	2,696	8.43	%
Real estate	304,362	18,074	5.94	%	324,863	20,754	6.39	%	321,225	21,209	6.60	%
Consumer and other	25,078	1,407	5.61	%	24,241	1,562	6.44	%	22,658	1,523	6.72	%
Total loans (including fees)	$434,468	$25,213	5.80	%	$463,782	$29,458	6.35	%	$454,088	$31,629	6.97	%
Investment securities												
Taxable	203,735	7,967	3.91	%	$196,619	$9,813	4.99	%	$198,689	$9,393	4.73	%
Tax-exempt 2	151,340	7,991	5.28	%	140,425	8,894	6.33	%	143,623	9,395	6.54	%
Total investment securities	$355,075	$15,958	4.49	%	$337,044	$18,707	5.55	%	$342,312	$18,788	5.49	%
Interest bearing deposits with banks	28,159	472	1.68	%	$5,053	$193	3.82	%	$864	$37	4.28	%
Federal funds sold	13,486	27	0.20	%	8,918	171	1.92	%	4,630	233	5.03	%
Total interest-earning assets	$831,189	$41,669	5.01	%	$814,797	$48,529	5.96	%	$801,894	$50,687	6.32	%
Noninterest-earning assets												
Cash and due from banks	$20,720				$19,581				$18,086			
Premises and equipment, net	12,216				13,007				13,618			
Other, less allowance for loan losses	15,932				10,320				10,190			
Total noninterest-earning assets	$48,868				$42,908				$41,894			
TOTAL ASSETS	$880,057				$857,705				$843,788			

1 Average loan balance includes nonaccrual loans, if any. Interest income collected on nonaccrual loans has been included.
2 Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental tax rate of 35%.

Table of Contents

Average Balances and Interest Rates (continued)

LIABILITIES AND STOCKHOLDERS' EQUITY

	2009			2008			2007		
(dollars in thousands)	Average balance	Revenue/ expense	Yield/ rate	Average balance	Revenue/ expense	Yield/ rate	Average balance	Revenue/ expense	Yield/ rate
Interest-bearing liabilities									
Deposits									
Savings, NOW accounts, and money markets	$355,504	$1,650	0.46 %	$317,346	$3,658	1.15 %	$309,787	$7,734	2.50 %
Time deposits < $100,000	157,749	4,488	2.84 %	170,223	6,603	3.88 %	179,740	7,996	4.45 %
Time deposits > $100,000	84,786	2,290	2.70 %	97,193	3,947	4.06 %	107,600	5,325	4.95 %
Total deposits	$598,040	$8,428	1.41 %	$584,762	$14,208	2.43 %	$597,127	$21,055	3.53 %
Other borrowed funds	83,841	1,798	2.14 %	78,764	2,194	2.79 %	57,047	2,482	4.35 %
Total Interest-bearing liabilities	$681,881	$10,226	1.50 %	$663,526	$16,402	2.47 %	$654,174	$23,537	3.60 %
Noninterest-bearing liabilities									
Demand deposits	84,245			78,033			70,459		
Other liabilities	5,519			8,352			7,784		
Stockholders' equity	108,412			107,794			111,371		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$880,057			$857,705			$843,788		
Net interest income		$31,443	3.78 %		$32,127	3.94 %		$27,150	3.39 %
Spread Analysis									

Interest income/average assets	$41,669	4.73	%	$48,529	5.66	%	$50,687	6.01	%
Interest expense/average assets	10,226	1.16	%	16,402	1.91	%	23,537	2.79	%
Net interest income/average assets	31,443	3.57	%	32,127	3.75	%	27,150	3.22	%

Rate and Volume Analysis

The rate and volume analysis is used to determine how much of the change in interest income or expense is the result of a change in volume or a change in interest rate. For example, commercial loan interest income decreased $1,379,000 in 2009 compared to 2008. Decreased volume of commercial loans lowered income in 2009 by $761,000 and lower interest rates lowered interest income in 2009 by $618,000.

Table of Contents

The following table sets forth, on a tax-equivalent basis, a summary of the changes in net interest income resulting from changes in volume and rates.

(dollars in thousands)	2009 Compared to 2008			2008 Compared to 2007		
	Volume	Rate	Total 1	Volume	Rate	Total 1
Interest income						
Loans						