

AMES NATIONAL CORP  
Form 10-Q  
May 08, 2014

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[Mark One]

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

For the quarterly period ended March 31, 2014

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

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

Commission File Number 0-32637

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

IOWA 42-1039071  
(State or Other Jurisdiction of Incorporation or Organization) (I. R. S. Employer Identification Number)

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

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

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

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

COMMON STOCK, \$2.00 PAR VALUE 9,310,913

(Class) Shares Outstanding at April 30, 2014)

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AMES NATIONAL CORPORATION

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## AMES NATIONAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(unaudited)

|                                                     | March 31,<br>2014      | December 31,<br>2013   |
|-----------------------------------------------------|------------------------|------------------------|
| <b>ASSETS</b>                                       |                        |                        |
| Cash and due from banks                             | \$30,409,845           | \$24,270,031           |
| Interest bearing deposits in financial institutions | 40,366,808             | 23,628,117             |
| Securities available-for-sale                       | 600,831,476            | 580,039,080            |
| Loans receivable, net                               | 548,545,071            | 564,501,547            |
| Loans held for sale                                 | -                      | 295,618                |
| Bank premises and equipment, net                    | 11,251,540             | 11,892,329             |
| Accrued income receivable                           | 7,432,502              | 7,437,673              |
| Other real estate owned                             | 8,880,467              | 8,861,107              |
| Deferred income taxes                               | 3,049,156              | 5,027,103              |
| Core deposit intangible, net                        | 963,816                | 1,029,564              |
| Goodwill                                            | 5,600,749              | 5,600,749              |
| Other assets                                        | 649,449                | 501,242                |
| <b>Total assets</b>                                 | <b>\$1,257,980,879</b> | <b>\$1,233,084,160</b> |

## LIABILITIES AND STOCKHOLDERS' EQUITY

## LIABILITIES

|                                                                                |                      |                      |
|--------------------------------------------------------------------------------|----------------------|----------------------|
| <b>Deposits</b>                                                                |                      |                      |
| Demand, noninterest bearing                                                    | \$173,459,774        | \$179,946,472        |
| NOW accounts                                                                   | 299,537,933          | 299,788,852          |
| Savings and money market                                                       | 316,704,817          | 289,307,102          |
| Time, \$100,000 and over                                                       | 95,697,308           | 97,077,717           |
| Other time                                                                     | 142,393,181          | 145,683,035          |
| <b>Total deposits</b>                                                          | <b>1,027,793,013</b> | <b>1,011,803,178</b> |
| <br>Securities sold under agreements to repurchase and federal funds purchased | <br>39,910,174       | <br>39,616,644       |
| Federal Home Loan Bank (FHLB) advances                                         | 16,722,546           | 14,540,526           |
| Other long-term borrowings                                                     | 20,000,000           | 20,000,000           |
| Dividend payable                                                               | 1,675,964            | 1,489,746            |
| Accrued expenses and other liabilities                                         | 4,691,477            | 3,527,882            |
| <b>Total liabilities</b>                                                       | <b>1,110,793,174</b> | <b>1,090,977,976</b> |

## STOCKHOLDERS' EQUITY

|                                                                                                                                                             |                    |                    |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------|--------------------|
| Common stock, \$2 par value, authorized 18,000,000 shares; issued 9,432,915 shares; outstanding 9,310,913 shares as of March 31, 2014 and December 31, 2013 | 18,865,830         | 18,865,830         |
| Additional paid-in capital                                                                                                                                  | 22,651,222         | 22,651,222         |
| Retained earnings                                                                                                                                           | 105,004,625        | 102,154,498        |
| Accumulated other comprehensive income - net unrealized gain on securities available-for-sale                                                               | 2,682,526          | 451,132            |
| Treasury stock, at cost; 122,002 shares at March 31, 2014 and December 31, 2013                                                                             | (2,016,498 )       | (2,016,498 )       |
| <b>Total stockholders' equity</b>                                                                                                                           | <b>147,187,705</b> | <b>142,106,184</b> |

|                                            |                 |                 |
|--------------------------------------------|-----------------|-----------------|
| Total liabilities and stockholders' equity | \$1,257,980,879 | \$1,233,084,160 |
|--------------------------------------------|-----------------|-----------------|

See Notes to Consolidated Financial Statements.

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## AMES NATIONAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

|                                                     | Three Months Ended<br>March 31, |             |
|-----------------------------------------------------|---------------------------------|-------------|
|                                                     | 2014                            | 2013        |
| Interest income:                                    |                                 |             |
| Loans, including fees                               | \$6,409,431                     | \$6,158,513 |
| Securities:                                         |                                 |             |
| Taxable                                             | 1,763,603                       | 1,379,962   |
| Tax-exempt                                          | 1,674,108                       | 1,728,433   |
| Interest bearing deposits and federal funds sold    | 73,139                          | 109,733     |
| Total interest income                               | 9,920,281                       | 9,376,641   |
| Interest expense:                                   |                                 |             |
| Deposits                                            | 892,010                         | 995,840     |
| Other borrowed funds                                | 294,486                         | 295,911     |
| Total interest expense                              | 1,186,496                       | 1,291,751   |
| Net interest income                                 | 8,733,785                       | 8,084,890   |
| Provision for loan losses                           | 39,231                          | 13,574      |
| Net interest income after provision for loan losses | 8,694,554                       | 8,071,316   |
| Noninterest income:                                 |                                 |             |
| Trust services income                               | 625,524                         | 487,254     |
| Service fees                                        | 357,479                         | 375,825     |
| Securities gains, net                               | 135,081                         | 68,991      |
| Gain on sale of loans held for sale                 | 98,653                          | 355,543     |
| Merchant and card fees                              | 259,389                         | 340,486     |
| Gain on the sale of premises and equipment          | 1,256,924                       | -           |
| Other noninterest income                            | 212,734                         | 214,869     |
| Total noninterest income                            | 2,945,784                       | 1,842,968   |
| Noninterest expense:                                |                                 |             |
| Salaries and employee benefits                      | 3,291,452                       | 3,216,082   |
| Data processing                                     | 571,350                         | 572,635     |
| Occupancy expenses, net                             | 469,220                         | 405,724     |
| FDIC insurance assessments                          | 162,344                         | 160,308     |
| Professional fees                                   | 282,447                         | 272,455     |
| Business development                                | 207,861                         | 191,351     |
| Other real estate owned, net                        | 704                             | (5,181 )    |
| Core deposit intangible amortization                | 65,748                          | 73,773      |
| Other operating expenses, net                       | 277,976                         | 231,949     |
| Total noninterest expense                           | 5,329,102                       | 5,119,096   |
| Income before income taxes                          | 6,311,236                       | 4,795,188   |

|                                      |             |             |
|--------------------------------------|-------------|-------------|
| Provision for income taxes           | 1,785,145   | 1,209,254   |
| Net income                           | \$4,526,091 | \$3,585,934 |
| Basic and diluted earnings per share | \$0.49      | \$0.39      |
| Dividends declared per share         | \$0.18      | \$0.16      |

See Notes to Consolidated Financial Statements.

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AMES NATIONAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

|                                                                    | Three Months Ended<br>March 31, |             |
|--------------------------------------------------------------------|---------------------------------|-------------|
|                                                                    | 2014                            | 2013        |
| Net income                                                         | \$4,526,091                     | \$3,585,934 |
| Other comprehensive income (loss), before tax:                     |                                 |             |
| Unrealized gains (losses) on securities before tax:                |                                 |             |
| Unrealized holding gains (losses) arising during the period        | 3,676,974                       | (1,613,929) |
| Less: reclassification adjustment for gains realized in net income | 135,081                         | 68,991      |
| Other comprehensive income (loss) before tax                       | 3,541,893                       | (1,682,920) |
| Tax effect related to other comprehensive income (loss)            | (1,310,499)                     | 622,680     |
| Other comprehensive income (loss), net of tax                      | 2,231,394                       | (1,060,240) |
| Comprehensive income                                               | \$6,757,485                     | \$2,525,694 |

See Notes to Consolidated Financial Statements.



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## AMES NATIONAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(unaudited)

Three Months Ended March 31, 2014 and 2013

|                                                 | Common<br>Stock | Additional<br>Paid-in-Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income, Net of<br>Taxes | Treasury<br>Stock | Total<br>Stockholders'<br>Equity |
|-------------------------------------------------|-----------------|-------------------------------|----------------------|------------------------------------------------------------------|-------------------|----------------------------------|
| Balance, December 31,<br>2012                   | \$18,865,830    | \$22,651,222                  | \$94,159,839         | \$11,075,342                                                     | \$(2,016,498)     | \$144,735,735                    |
| Net income                                      | -               | -                             | 3,585,934            | -                                                                | -                 | 3,585,934                        |
| Other comprehensive<br>(loss)                   | -               | -                             | -                    | (1,060,240 )                                                     | -                 | (1,060,240 )                     |
| Cash dividends<br>declared, \$0.16 per<br>share | -               | -                             | (1,489,747 )         | -                                                                | -                 | (1,489,747 )                     |
| Balance, March 31,<br>2013                      | \$18,865,830    | \$22,651,222                  | \$96,256,026         | \$10,015,102                                                     | \$(2,016,498)     | \$145,771,682                    |
| Balance, December 31,<br>2013                   | \$18,865,830    | \$22,651,222                  | \$102,154,498        | \$451,132                                                        | \$(2,016,498)     | \$142,106,184                    |
| Net income                                      | -               | -                             | 4,526,091            | -                                                                | -                 | 4,526,091                        |
| Other comprehensive<br>income                   | -               | -                             | -                    | 2,231,394                                                        | -                 | 2,231,394                        |
| Cash dividends<br>declared, \$0.18 per<br>share | -               | -                             | (1,675,964 )         | -                                                                | -                 | (1,675,964 )                     |
| Balance, March 31,<br>2014                      | \$18,865,830    | \$22,651,222                  | \$105,004,625        | \$2,682,526                                                      | \$(2,016,498)     | \$147,187,705                    |

See Notes to Consolidated Financial Statements.

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## AMES NATIONAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

Three Months Ended March 31, 2014 and 2013

|                                                                                        | 2014         | 2013         |
|----------------------------------------------------------------------------------------|--------------|--------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                            |              |              |
| Net income                                                                             | \$4,526,091  | \$3,585,934  |
| Adjustments to reconcile net income to net cash provided by operating activities:      |              |              |
| Provision for loan losses                                                              | 39,231       | 13,574       |
| Provision for off-balance sheet commitments                                            | 35,000       | 14,000       |
| Amortization, net, securities available-for-sale                                       | 1,099,195    | 1,649,643    |
| Amortization of core deposit intangible asset                                          | 65,748       | 73,773       |
| Depreciation                                                                           | 187,611      | 190,428      |
| Credit for deferred income taxes                                                       | 667,448      | 29,639       |
| Securities gains, net                                                                  | (135,081 )   | (68,991 )    |
| (Gain) on sale of premises and equipment                                               | (1,256,924 ) | -            |
| (Gain) on sale of other real estate owned, net                                         | -            | (25,351 )    |
| Change in assets and liabilities:                                                      |              |              |
| Increase (decrease) in loans held for sale                                             | 295,618      | (423,802 )   |
| Decrease in accrued income receivable                                                  | 5,171        | 12,636       |
| (Increase) in other assets                                                             | (150,386 )   | (62,459 )    |
| Increase in accrued expenses and other liabilities                                     | 1,128,595    | 1,187,690    |
| Net cash provided by operating activities                                              | 6,507,317    | 6,176,714    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                            |              |              |
| Purchase of securities available-for-sale                                              | (35,980,382) | (48,732,167) |
| Proceeds from sale of securities available-for-sale                                    | 3,478,851    | 1,701,395    |
| Proceeds from maturities and calls of securities available-for-sale                    | 14,209,166   | 23,698,932   |
| Net (increase) in interest bearing deposits in financial institutions                  | (16,738,691) | (31,431,850) |
| Net decrease in loans                                                                  | 15,939,754   | 2,398,188    |
| Net proceeds from the sale of other real estate owned                                  | -            | 334,068      |
| Net proceeds from the sale of bank premises and equipment                              | 1,746,444    | -            |
| Purchase of bank premises and equipment, net                                           | (34,163 )    | (27,089 )    |
| Other                                                                                  | (2,750 )     | -            |
| Net cash used in investing activities                                                  | (17,381,771) | (52,058,523) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                            |              |              |
| Increase in deposits                                                                   | 16,028,464   | 29,552,707   |
| Increase in securities sold under agreements to repurchase and federal funds purchased | 293,530      | 7,633,505    |
| Payments on FHLB borrowings                                                            | (17,980 )    | (2,017,417 ) |
| Proceeds from short-term FHLB borrowings, net                                          | 2,200,000    | -            |
| Dividends paid                                                                         | (1,489,746 ) | (1,396,627 ) |
| Net cash provided by financing activities                                              | 17,014,268   | 33,772,168   |
| Net increase (decrease) in cash and due from banks                                     | 6,139,814    | (12,109,641) |
| <b>CASH AND DUE FROM BANKS</b>                                                         |              |              |
| Beginning                                                                              | 24,270,031   | 34,805,371   |

|        |              |              |
|--------|--------------|--------------|
| Ending | \$30,409,845 | \$22,695,730 |
|--------|--------------|--------------|

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AMES NATIONAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)  
(unaudited)

Three Months Ended March 31, 2014 and 2013

|  | 2014 | 2013 |
|--|------|------|
|--|------|------|

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for:

|              |              |              |
|--------------|--------------|--------------|
| Interest     | \$ 1,275,692 | \$ 1,394,056 |
| Income taxes | 48,701       | 55,440       |

SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES

|                                                         |           |          |
|---------------------------------------------------------|-----------|----------|
| Transfer of loans receivable to other real estate owned | \$ 16,610 | \$ 5,205 |
|---------------------------------------------------------|-----------|----------|

See Notes to Consolidated Financial Statements.

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AMES NATIONAL CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (unaudited)

1. Significant Accounting Policies

The consolidated financial statements for the three months ended March 31, 2014 and 2013 are unaudited. In the opinion of the management of Ames National Corporation (the "Company"), these financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary to present fairly these consolidated financial statements. The results of operations for the interim periods are not necessarily indicative of results which may be expected for an entire year. Certain information and footnote disclosures normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in accordance with the requirements for interim financial statements. The interim financial statements and notes thereto should be read in conjunction with the year-end audited financial statements contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 (the "Annual Report"). The consolidated financial statements include the accounts of the Company and its wholly-owned banking subsidiaries (the "Banks"). All significant intercompany balances and transactions have been eliminated in consolidation.

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

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions and selecting an appropriate control premium. At March 31, 2014, Company management has performed a goodwill impairment analysis and determined goodwill was not impaired.

**New Accounting Pronouncements:** In January 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-04, Receivables—Troubled Debt Restructuring by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure. The update clarifies when an in substance foreclosure occurs, that is, when a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan. This is the point when the consumer mortgage loan should be derecognized and the real property recognized. For public companies, this update will be effective for interim and annual periods beginning after December 31, 2014 and early adoption is permitted. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

2. Dividends

On February 11, 2014, the Company declared a cash dividend on its common stock, payable on May 15, 2014 to stockholders of record as of May 1, 2014, equal to \$0.18 per share.

3. Earnings Per Share

Earnings per share amounts were calculated using the weighted average shares outstanding during the periods presented. The weighted average outstanding shares for the three months ended March 31, 2014 and 2013 were 9,310,913. The Company had no potentially dilutive securities outstanding during the periods presented.



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4. Off-Balance Sheet Arrangements

The Company is party to financial instruments with off-balance sheet risk in the normal course of business. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. No material changes in the Company's off-balance sheet arrangements have occurred since December 31, 2013.

5. Fair Value Measurements

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

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

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

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

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The following table presents the balances of assets measured at fair value on a recurring basis by level as of March 31, 2014 and December 31, 2013.

| Description                                        | Total         | Level 1   | Level 2       | Level 3 |
|----------------------------------------------------|---------------|-----------|---------------|---------|
| 2014                                               |               |           |               |         |
| U.S. government agencies                           | \$86,396,000  | \$-       | \$86,396,000  | \$ -    |
| U.S. government mortgage-backed securities         | 150,010,000   | -         | 150,010,000   | -       |
| State and political subdivisions                   | 314,176,000   | -         | 314,176,000   | -       |
| Corporate bonds                                    | 46,460,000    | -         | 46,460,000    | -       |
| Equity securities, financial industry common stock | 776,000       | 776,000   | -             | -       |
| Equity securities, other                           | 3,013,000     | -         | 3,013,000     | -       |
|                                                    | \$600,831,000 | \$776,000 | \$600,055,000 | \$ -    |
| 2013                                               |               |           |               |         |
| U.S. government agencies                           | \$61,178,000  | \$-       | \$61,178,000  | \$ -    |
| U.S. government mortgage-backed securities         | 155,142,000   | -         | 155,142,000   | -       |
| State and political subdivisions                   | 315,224,000   | -         | 315,224,000   | -       |
| Corporate bonds                                    | 44,752,000    | -         | 44,752,000    | -       |
| Equity securities, financial industry common stock | 841,000       | 841,000   | -             | -       |
| Equity securities, other                           | 2,902,000     | -         | 2,902,000     | -       |
|                                                    | \$580,039,000 | \$841,000 | \$579,198,000 | \$ -    |

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



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Certain assets are measured at fair value on a nonrecurring basis; that is, they are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets carried on the balance sheet (after specific reserves) by caption and by level with the valuation hierarchy as of March 31, 2014 and December 31, 2013.

| Description             | Total       | Level<br>1 | Level<br>2 | Level 3     |
|-------------------------|-------------|------------|------------|-------------|
| 2014                    |             |            |            |             |
| Loans receivable        | \$752,000   | \$ -       | \$ -       | \$752,000   |
| Other real estate owned | 8,880,000   | -          | -          | 8,880,000   |
| Total                   | \$9,632,000 | \$ -       | \$ -       | \$9,632,000 |
| 2013                    |             |            |            |             |
| Loans receivable        | \$648,000   | \$ -       | \$ -       | \$648,000   |
| Other real estate owned | 8,861,000   | -          | -          | 8,861,000   |
| Total                   | \$9,509,000 | \$ -       | \$ -       | \$9,509,000 |

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

Other Real Estate Owned: Other real estate owned in the table above consists of real estate obtained through foreclosure. Other real estate owned is recorded at fair value less estimated selling costs, at the date of transfer. Subsequent to the transfer, other real estate owned is carried at the lower of cost or fair value, less estimated selling costs. The carrying value of other real estate owned is not re-measured to fair value on a recurring basis but is subject to fair value adjustments when the carrying value exceeds the fair value less estimated selling costs. Management uses appraised values and adjusts for trends observed in the market and for disposition costs in determining the value of other real estate owned. A valuation allowance was recorded for the excess of the asset's recorded investment over the amount determined by the fair value, less estimated selling costs. This valuation allowance is a component of the allowance for other real estate owned. The valuation allowance was \$4,644,000 as of March 31, 2014 and December 31, 2013. The Company considers these fair values level 3.

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

| 2014                    |             |                          |                              |                 |
|-------------------------|-------------|--------------------------|------------------------------|-----------------|
|                         | Fair Value  | Valuation Techniques     | Range of Unobservable Inputs | Range (Average) |
| Impaired Loans          | \$752,000   | Evaluation of collateral | Estimation of value          | NM*             |
| Other real estate owned | \$8,880,000 | Appraisal                | Appraisal adjustment         | 6%-10% (8%)     |
| 2013                    |             |                          |                              |                 |
|                         | Fair Value  | Valuation Techniques     | Range of Unobservable Inputs | Range (Average) |
| Impaired Loans          | \$648,000   | Evaluation of collateral | Estimation of value          | NM*             |
| Other real estate owned | \$8,861,000 | Appraisal                | Appraisal adjustment         | 6%-10% (8%)     |

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

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

#### Fair value of financial instruments:

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

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

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

Securities available-for-sale: Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the securities credit rating, prepayment assumptions and other factors such as credit loss assumptions.

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

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

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

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

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

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

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

Limitations: Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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The estimated fair values of the Company's financial instruments as described above were as follows:

|                                                   |                                  | March 31,<br>2014  |                 | December 31,<br>2013 |                 |
|---------------------------------------------------|----------------------------------|--------------------|-----------------|----------------------|-----------------|
|                                                   | Fair Value<br>Hierarchy<br>Level | Carrying<br>Amount | Fair<br>Value   | Carrying<br>Amount   | Fair<br>Value   |
| Financial assets:                                 |                                  |                    |                 |                      |                 |
| Cash and due from banks                           | Level 1                          | \$30,409,845       | \$30,410,000    | \$24,270,031         | \$24,270,000    |
| Interest bearing deposits                         | Level 1                          | 40,366,808         | 40,367,000      | 23,628,117           | 23,628,000      |
| Securities available-for-sale                     | See previous<br>table            | 600,831,476        | 600,831,000     | 580,039,080          | 580,039,000     |
| Loans receivable, net                             | Level 2                          | 548,545,071        | 548,149,000     | 564,501,547          | 562,073,000     |
| Loans held for sale                               | Level 2                          | -                  | -               | 295,618              | 296,000         |
| Accrued income receivable                         | Level 1                          | 7,432,502          | 7,433,000       | 7,437,673            | 7,438,000       |
| Financial liabilities:                            |                                  |                    |                 |                      |                 |
| Deposits                                          | Level 2                          | \$1,027,793,013    | \$1,029,998,781 | \$1,011,803,178      | \$1,014,150,000 |
| Securities sold under agreements<br>to repurchase | Level 1                          | 39,910,174         | 39,910,000      | 39,616,644           | 39,617,000      |
| FHLB advances                                     | Level 2                          | 16,722,546         | 17,577,000      | 14,540,526           | 15,441,000      |
| Other long-term borrowings                        | Level 2                          | 20,000,000         | 21,754,000      | 20,000,000           | 22,033,000      |
| Accrued interest payable                          | Level 1                          | 543,656            | 544,000         | 594,223              | 594,000         |

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

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## 6. Debt and Equity Securities

The amortized cost of securities available-for-sale and their fair values are summarized below:

|                                                    | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value    |
|----------------------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2014:                                    |                   |                              |                               |               |
| U.S. government agencies                           | \$86,250,287      | \$1,179,941                  | \$(1,034,378)                 | \$86,395,850  |
| U.S. government mortgage-backed securities         | 147,744,732       | 2,970,908                    | (705,335 )                    | 150,010,305   |
| State and political subdivisions                   | 311,717,311       | 5,278,009                    | (2,818,889)                   | 314,176,431   |
| Corporate bonds                                    | 47,218,869        | 731,812                      | (1,490,191)                   | 46,460,490    |
| Equity securities, financial industry common stock | 629,700           | 146,100                      | -                             | 775,800       |
| Equity securities, other                           | 3,012,600         | -                            | -                             | 3,012,600     |
|                                                    | \$596,573,499     | \$10,306,770                 | \$(6,048,793)                 | \$600,831,476 |

|                                                    | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value    |
|----------------------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2013:                                 |                   |                              |                               |               |
| U.S. government agencies                           | \$61,569,302      | \$1,116,644                  | \$(1,508,155)                 | \$61,177,791  |
| U.S. government mortgage-backed securities         | 153,857,058       | 2,846,821                    | (1,561,923)                   | 155,141,956   |
| State and political subdivisions                   | 314,177,458       | 5,055,906                    | (4,009,231)                   | 315,224,133   |
| Corporate bonds                                    | 46,186,879        | 756,222                      | (2,191,401)                   | 44,751,700    |
| Equity securities, financial industry common stock | 629,700           | 211,200                      | -                             | 840,900       |
| Equity securities, other                           | 2,902,600         | -                            | -                             | 2,902,600     |
|                                                    | \$579,322,997     | \$9,986,793                  | \$(9,270,710)                 | \$580,039,080 |

The proceeds, gains and losses from securities available-for-sale are summarized as follows:

|                                                                                 | Three Months Ended<br>March 31, |             |
|---------------------------------------------------------------------------------|---------------------------------|-------------|
|                                                                                 | 2014                            | 2013        |
| Proceeds from sales of securities available-for-sale                            | \$3,478,851                     | \$1,701,395 |
| Gross realized gains on securities available-for-sale                           | 135,081                         | 70,502      |
| Gross realized losses on securities available-for-sale                          | -                               | 1,511       |
| Tax provision applicable to net realized gains on securities available-for-sale | 50,000                          | 26,000      |

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

|                                            | Less than 12 Months |                   | 12 Months or More |                   | Total         |                   |
|--------------------------------------------|---------------------|-------------------|-------------------|-------------------|---------------|-------------------|
|                                            | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value    | Unrealized Losses |
| March 31, 2014:                            |                     |                   |                   |                   |               |                   |
| Securities available-for-sale:             |                     |                   |                   |                   |               |                   |
| U.S. government agencies                   | \$35,509,515        | \$(1,034,378)     | \$-               | \$-               | \$35,509,515  | \$(1,034,378)     |
| U.S. government mortgage-backed securities | 52,185,115          | (653,242 )        | 2,679,015         | (52,093 )         | 54,864,130    | (705,335 )        |
| State and political subdivisions           | 88,082,052          | (1,925,797)       | 20,322,416        | (893,092 )        | 108,404,468   | (2,818,889)       |
| Corporate bonds                            | 16,103,518          | (472,849 )        | 15,274,024        | (1,017,342)       | 31,377,542    | (1,490,191)       |
|                                            | \$191,880,200       | \$(4,086,266)     | \$38,275,455      | \$(1,962,527)     | \$230,155,655 | \$(6,048,793)     |

|                                            | Less than 12 Months |                   | 12 Months or More |                   | Total         |                   |
|--------------------------------------------|---------------------|-------------------|-------------------|-------------------|---------------|-------------------|
|                                            | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value    | Unrealized Losses |
| December 31, 2013:                         |                     |                   |                   |                   |               |                   |
| Securities available-for-sale:             |                     |                   |                   |                   |               |                   |
| U.S. government agencies                   | \$31,806,447        | \$(1,508,155)     | \$-               | \$-               | \$31,806,447  | \$(1,508,155)     |
| U.S. government mortgage-backed securities | 71,326,568          | (1,479,321)       | 2,771,874         | (82,602 )         | 74,098,442    | (1,561,923)       |
| State and political subdivisions           | 99,974,091          | (3,028,851)       | 15,438,484        | (980,380 )        | 115,412,575   | (4,009,231)       |
| Corporate bonds                            | 21,382,087          | (1,150,658)       | 8,798,047         | (1,040,743)       | 30,180,134    | (2,191,401)       |
|                                            | \$224,489,193       | \$(7,166,985)     | \$27,008,405      | \$(2,103,725)     | \$251,497,598 | \$(9,270,710)     |

Gross unrealized losses on debt securities totaled \$6,048,793 as of March 31, 2014. These unrealized losses are generally due to changes in interest rates or general market conditions. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and industry analysts' reports. Management concluded that the gross unrealized losses on debt securities were temporary. Due to potential changes in conditions, it is at least reasonably possible that changes in fair values and management's assessments will occur in the near term and that such changes could materially affect the amounts reported in the Company's financial statements.

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## 7.Loan Receivable and Credit Disclosures

Activity in the allowance for loan losses, on a disaggregated basis, for the three months ended March 31, 2014 and 2013 is as follows: (in thousands)

|                                    | Three Months Ended March 31, 2014 |                |                |                              |                                |            |              |                          |
|------------------------------------|-----------------------------------|----------------|----------------|------------------------------|--------------------------------|------------|--------------|--------------------------|
|                                    | 1-4<br>Family<br>Construction     | Real<br>Estate | Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural | Consumer<br>and<br>Other |
|                                    | Real<br>Estate                    | Real<br>Estate | Real<br>Estate | Real<br>Estate               | Real<br>Estate                 | Commercial | Agricultural | Other                    |
| Balance, December 31, 2013         | \$392                             | \$ 1,523       | \$ 3,230       | \$ 686                       | \$ 1,435                       | \$ 1,165   | \$ 141       | \$8,572                  |
| Provision (credit) for loan losses | 48                                | 18             | (31 )          | 45                           | (31 )                          | (58 )      | 48           | 39                       |
| Recoveries of loans charged-off    | -                                 | 4              | -              | -                            | 1                              | -          | 5            | 10                       |
| Loans charged-off                  | -                                 | (5 )           | -              | -                            | -                              | -          | (48 )        | (53 )                    |
| Balance, March 31 2014             | \$440                             | \$ 1,540       | \$ 3,199       | \$ 731                       | \$ 1,405                       | \$ 1,107   | \$ 146       | \$8,568                  |

|                                    | Three Months Ended March 31, 2013 |                |                |                              |                                |            |              |                          |
|------------------------------------|-----------------------------------|----------------|----------------|------------------------------|--------------------------------|------------|--------------|--------------------------|
|                                    | 1-4<br>Family<br>Construction     | Real<br>Estate | Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural | Consumer<br>and<br>Other |
|                                    | Real<br>Estate                    | Real<br>Estate | Real<br>Estate | Real<br>Estate               | Real<br>Estate                 | Commercial | Agricultural | Other                    |
| Balance, December 31, 2012         | \$375                             | \$ 1,433       | \$ 2,859       | \$ 523                       | \$ 1,461                       | \$ 945     | \$ 177       | \$7,773                  |
| Provision (credit) for loan losses | (49 )                             | 61             | 216            | 1                            | (157 )                         | (41 )      | (17 )        | 14                       |
| Recoveries of loans charged-off    | -                                 | 21             | -              | -                            | 1                              | -          | 4            | 26                       |
| Loans charged-off                  | -                                 | (23 )          | -              | -                            | -                              | -          | (4 )         | (27 )                    |
| Balance, March 31, 2013            | \$326                             | \$ 1,492       | \$ 3,075       | \$ 524                       | \$ 1,305                       | \$ 904     | \$ 160       | \$7,786                  |

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

2014

|                                       | 1-4<br>Family<br>Construction |                |                              |                                |            |              |                          |         |
|---------------------------------------|-------------------------------|----------------|------------------------------|--------------------------------|------------|--------------|--------------------------|---------|
|                                       | Real<br>Estate                | Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural | Consumer<br>and<br>Other | Total   |
| Individually evaluated for impairment | \$-                           | \$ 122         | \$ 20                        | \$ -                           | \$ 300     | \$ 4         | \$ -                     | \$446   |
| Collectively evaluated for impairment | 440                           | 1,418          | 3,179                        | 731                            | 1,105      | 1,103        | 146                      | 8,122   |
| Balance March 31, 2014                | \$440                         | \$ 1,540       | \$ 3,199                     | \$ 731                         | \$ 1,405   | \$ 1,107     | \$ 146                   | \$8,568 |



2013

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

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

2014

|                                          | Constructive   | 1-4<br>Family<br>Residential | Commercial     | Agricultural   |            |              | Consumer<br>and<br>Other | Total     |
|------------------------------------------|----------------|------------------------------|----------------|----------------|------------|--------------|--------------------------|-----------|
|                                          | Real<br>Estate | Real<br>Estate               | Real<br>Estate | Real<br>Estate | Commercial | Agricultural |                          |           |
| Individually evaluated<br>for impairment | \$496          | \$461                        | \$90           | \$ -           | \$ 796     | \$ 23        | \$ 14                    | \$1,880   |
| Collectively evaluated<br>for impairment | 25,297         | 111,845                      | 198,818        | 52,234         | 82,723     | 71,851       | 12,503                   | 555,271   |
| Balance March 31,<br>2014                | \$25,793       | \$112,306                    | \$198,908      | \$52,234       | \$83,519   | \$71,874     | \$12,517                 | \$557,151 |

2013

|                                          | Constructive   | 1-4<br>Family<br>Residential | Commercial     | Agricultural   |            |              | Consumer<br>and<br>Other | Total     |
|------------------------------------------|----------------|------------------------------|----------------|----------------|------------|--------------|--------------------------|-----------|
|                                          | Real<br>Estate | Real<br>Estate               | Real<br>Estate | Real<br>Estate | Commercial | Agricultural |                          |           |
| Individually evaluated<br>for impairment | \$510          | \$784                        | \$526          | \$ -           | \$ 816     | \$ 24        | \$ 61                    | \$2,721   |
| Collectively evaluated<br>for impairment | 23,418         | 107,506                      | 205,585        | 53,834         | 86,007     | 81,302       | 12,734                   | 570,386   |
| Balance December 31,<br>2013             | \$23,928       | \$108,290                    | \$206,111      | \$53,834       | \$86,823   | \$81,326     | \$12,795                 | \$573,107 |

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A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payment of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. The Company will apply its normal loan review procedures to identify loans that should be evaluated for impairment. The following is a recap of impaired loans, on a disaggregated basis, at March 31, 2014 and December 31, 2013: (in thousands)

|                                         | March 31, 2014 |           |           | December 31, 2013 |           |           |
|-----------------------------------------|----------------|-----------|-----------|-------------------|-----------|-----------|
|                                         | Unpaid         |           |           | Unpaid            |           |           |
|                                         | Recorded       | Principal | Related   | Recorded          | Principal | Related   |
|                                         | Investment     | Balance   | Allowance | Investment        | Balance   | Allowance |
| With no specific reserve recorded:      |                |           |           |                   |           |           |
| Real estate - construction              | \$496          | \$ 496    | \$ -      | \$510             | \$ 510    | \$ -      |
| Real estate - 1 to 4 family residential | 65             | 65        | -         | 483               | 483       | -         |
| Real estate - commercial                | 44             | 44        | -         | 480               | 480       | -         |
| Real estate - agricultural              | -              | -         | -         | -                 | -         | -         |
| Commercial                              | 44             | 44        | -         | 43                | 43        | -         |
| Agricultural                            | 19             | 19        | -         | 19                | 19        | -         |
| Consumer and other                      | 14             | 14        | -         | 61                | 61        | -         |
| Total loans with no specific reserve:   | 682            | 682       | -         | 1,596             | 1,596     | -         |
| With an allowance recorded:             |                |           |           |                   |           |           |
| Real estate - construction              | -              | -         | -         | -                 | -         | -         |
| Real estate - 1 to 4 family residential | 396            | 396       | 122       | 301               | 301       | 122       |
| Real estate - commercial                | 46             | 46        | 20        | 46                | 46        | 20        |
| Real estate - agricultural              | -              | -         | -         | -                 | -         | -         |
| Commercial                              | 752            | 752       | 300       | 773               | 773       | 330       |
| Agricultural                            | 4              | 4         | 4         | 5                 | 5         | 5         |
| Consumer and other                      | -              | -         | -         | -                 | -         | -         |
| Total loans with specific reserve:      | 1,198          | 1,198     | 446       | 1,125             | 1,125     | 477       |
| Total                                   |                |           |           |                   |           |           |
| Real estate - construction              | 496            | 496       | -         | 510               | 510       | -         |
| Real estate - 1 to 4 family residential | 461            | 461       | 122       | 784               | 784       | 122       |
| Real estate - commercial                | 90             | 90        | 20        | 526               | 526       | 20        |
| Real estate - agricultural              | -              | -         | -         | -                 | -         | -         |
| Commercial                              | 796            | 796       | 300       | 816               | 816       | 330       |
| Agricultural                            | 23             | 23        | 4         | 24                | 24        | 5         |
| Consumer and other                      | 14             | 14        | -         | 61                | 61        | -         |
|                                         | \$1,880        | \$ 1,880  | \$ 446    | \$2,721           | \$ 2,721  | \$ 477    |

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The following is a recap of the average recorded investment and interest income recognized on impaired loans for the three months ended March 31, 2014 and 2013: (in thousands)

|                                         | Three Months Ended March 31, |            | 2013             |            |
|-----------------------------------------|------------------------------|------------|------------------|------------|
|                                         | 2014                         |            | 2013             |            |
|                                         | Average Interest             |            | Average Interest |            |
|                                         | Recorded Income              |            | Recorded Income  |            |
|                                         | Investment                   | Recognized | Investment       | Recognized |
| With no specific reserve recorded:      |                              |            |                  |            |
| Real estate - construction              | \$503                        | \$ -       | \$1,033          | \$ -       |
| Real estate - 1 to 4 family residential | 274                          | 5          | 660              | -          |
| Real estate - commercial                | 262                          | 28         | 996              | 2          |
| Real estate - agricultural              | -                            | -          | -                | -          |
| Commercial                              | 43                           | -          | 75               | -          |
| Agricultural                            | 19                           | -          | -                | -          |
| Consumer and other                      | 38                           | -          | 4                | -          |
| Total loans with no specific reserve:   | 1,139                        | 33         | 2,768            | 2          |
| With an allowance recorded:             |                              |            |                  |            |
| Real estate - construction              | -                            | -          | 431              | -          |
| Real estate - 1 to 4 family residential | 349                          | -          | 506              | -          |
| Real estate - commercial                | 46                           | -          | 2,248            | -          |
| Real estate - agricultural              | -                            | -          | -                | -          |
| Commercial                              | 764                          | -          | 676              | -          |
| Agricultural                            | 5                            | -          | 6                | -          |
| Consumer and other                      | -                            | -          | 1                | -          |
| Total loans with specific reserve:      | 1,164                        | -          | 3,868            | -          |
| Total                                   |                              |            |                  |            |
| Real estate - construction              | 503                          | -          | 1,464            | -          |
| Real estate - 1 to 4 family residential | 623                          | 5          | 1,166            | -          |
| Real estate - commercial                | 308                          | 28         | 3,244            | 2          |
| Real estate - agricultural              | -                            | -          | -                | -          |
| Commercial                              | 807                          | -          | 751              | -          |
| Agricultural                            | 24                           | -          | 6                | -          |
| Consumer and other                      | 38                           | -          | 5                | -          |
|                                         | \$2,303                      | \$ 33      | \$6,636          | \$ 2       |

The interest foregone on nonaccrual loans for the three months ended March 31, 2014 and 2013 was approximately \$37,000 and \$85,000, respectively.

The Company had loans meeting the definition of a troubled debt restructuring (TDR) of \$1,223,000 as of March 31, 2014, of which all were included in impaired loans and nonaccrual loans. The Company had TDRs of \$1,424,000 as of December 31, 2013, all of which were included in impaired loans, \$1,237,000 was included as nonaccrual loans and \$187,000 was on accrual status.

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The following table sets forth information on the Company's TDRs, on a disaggregated basis, occurring in the three months ended March 31, 2014 and 2013: (dollars in thousands)

|                                            | Three Months Ended March 31,<br>2014       |       |                                  | 2013                                       |      |                                  |
|--------------------------------------------|--------------------------------------------|-------|----------------------------------|--------------------------------------------|------|----------------------------------|
|                                            | Pre-Modification<br>Outstanding            |       | Post-Modification<br>Outstanding | Pre-Modification<br>Outstanding            |      | Post-Modification<br>Outstanding |
|                                            | Number<br>of Recorded<br>Contra Investment |       | Recorded<br>Investment           | Number<br>of Recorded<br>Contra Investment |      | Recorded<br>Investment           |
|                                            |                                            |       |                                  |                                            |      |                                  |
| Real estate - construction                 | -                                          | \$ -  | \$ -                             | -                                          | \$ - | \$ -                             |
| Real estate - 1 to 4 family<br>residential | -                                          | -     | -                                | -                                          | -    | -                                |
| Real estate - commercial                   | 1                                          | 43    | 43                               | -                                          | -    | -                                |
| Real estate - agricultural                 | -                                          | -     | -                                | -                                          | -    | -                                |
| Commercial                                 | -                                          | -     | -                                | -                                          | -    | -                                |
| Agricultural                               | 1                                          | 19    | 19                               | -                                          | -    | -                                |
| Consumer and other                         | 1                                          | 6     | 6                                | -                                          | -    | -                                |
|                                            | 3                                          | \$ 68 | \$ 68                            | -                                          | \$ - | \$ -                             |

During the three months ended March 31, 2014, the Company granted concessions to two borrowers experiencing financial difficulties. The commercial real estate loan was restructured as an interest only loan for a period of time. The agricultural and consumer loans maturity date was extended one year with interest only until maturity.

There was no new TDR activity in the three months ended March 31, 2013.

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

There was one charge-off related to a TDR for the three months ended March 31, 2014 in the amount of \$44,000 and no charge-offs related to TDRs for the three months ended March 31, 2013. There was no impact for specific reserves for the three months ended March 31, 2014 and 2013.

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

## 2014

|                                         | 90 Days<br>or<br>Greater<br>Past<br>Due |                        |                      | Current  | Total    | 90 Days<br>or<br>Greater<br>Accruing |
|-----------------------------------------|-----------------------------------------|------------------------|----------------------|----------|----------|--------------------------------------|
|                                         | 30-89<br>Past<br>Due                    | Greater<br>Past<br>Due | Total<br>Past<br>Due |          |          |                                      |
| Real estate - construction              | \$-                                     | \$ -                   | \$-                  | \$25,793 | \$25,793 | \$ -                                 |
| Real estate - 1 to 4 family residential | 728                                     | 266                    | 994                  | 111,312  | 112,306  | -                                    |
| Real estate - commercial                | 72                                      | 46                     | 118                  | 198,790  | 198,908  | -                                    |
| Real estate - agricultural              | -                                       | -                      | -                    | 52,234   | 52,234   | -                                    |
| Commercial                              | 101                                     | 24                     | 125                  | 83,394   | 83,519   | -                                    |
| Agricultural                            | 617                                     | -                      | 617                  | 71,257   | 71,874   | -                                    |

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|                    |         |        |         |           |           |      |
|--------------------|---------|--------|---------|-----------|-----------|------|
| Consumer and other | 281     | -      | 281     | 12,236    | 12,517    | -    |
|                    | \$1,799 | \$ 336 | \$2,135 | \$555,016 | \$557,151 | \$ - |

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2013

|                                         | 30-89<br>Past<br>Due | 90 Days<br>or<br>Greater<br>Past<br>Due | Total<br>Past<br>Due | Current   | Total     | 90 Days<br>or<br>Greater<br>Accruing |
|-----------------------------------------|----------------------|-----------------------------------------|----------------------|-----------|-----------|--------------------------------------|
| Real estate - construction              | \$-                  | \$-                                     | \$-                  | \$23,928  | \$23,928  | \$ -                                 |
| Real estate - 1 to 4 family residential | 1,059                | 4,000                                   | 5,059                | 103,230   | 108,289   | 27                                   |
| Real estate - commercial                | -                    | 46                                      | 46                   | 206,066   | 206,112   | -                                    |
| Real estate - agricultural              | -                    | -                                       | -                    | 53,834    | 53,834    | -                                    |
| Commercial                              | 88                   | 375                                     | 463                  | 86,360    | 86,823    | -                                    |
| Agricultural                            | -                    | -                                       | -                    | 81,326    | 81,326    | -                                    |
| Consumer and other                      | 35                   | -                                       | 35                   | 12,760    | 12,795    | -                                    |
|                                         | \$1,182              | \$4,421                                 | \$5,603              | \$567,504 | \$573,107 | \$ 27                                |

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

2014

|                      | Construction<br>Real Estate | Commercial<br>Real Estate | Agricultural<br>Real Estate | Commercial | Agricultural | Total     |
|----------------------|-----------------------------|---------------------------|-----------------------------|------------|--------------|-----------|
| Pass                 | \$ 19,810                   | \$ 167,072                | \$ 49,775                   | \$ 72,224  | \$ 70,171    | \$379,052 |
| Watch                | 2,964                       | 20,571                    | 2,346                       | 9,080      | 1,339        | 36,300    |
| Special Mention      | -                           | 746                       | -                           | -          | 90           | 836       |
| Substandard          | 2,523                       | 10,429                    | 113                         | 1,419      | 251          | 14,735    |
| Substandard-Impaired | 496                         | 90                        | -                           | 796        | 23           | 1,405     |
|                      | \$ 25,793                   | \$ 198,908                | \$ 52,234                   | \$ 83,519  | \$ 71,874    | \$432,328 |

2013

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

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

2014

|                | 1-4 Family<br>Residential<br>Real Estate | Consumer<br>and Other | Total      |
|----------------|------------------------------------------|-----------------------|------------|
| Performing     | \$ 111,845                               | \$ 12,504             | \$ 124,349 |
| Non-performing | 461                                      | 13                    | 474        |
|                | \$ 112,306                               | \$ 12,517             | \$ 124,823 |

2013

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

#### 8. Other Real Estate Owned

The following table provides the composition of other real estate owned as of March 31, 2014 and December 31, 2013:

|                                       | 2014        | 2013        |
|---------------------------------------|-------------|-------------|
| Construction and land development     | \$6,750,503 | \$6,750,503 |
| 1 to 4 family residential real estate | 1,315,587   | 1,296,227   |
| Commercial real estate                | 814,377     | 814,377     |
|                                       | \$8,880,467 | \$8,861,107 |

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

#### 9. Goodwill

Goodwill was recognized in 2012 due to the acquisition which resulted in an expanded market area. The goodwill resulted from a premium paid related to this acquisition. The goodwill is not amortized but is evaluated for impairment at least annually. For income tax purposes, goodwill is amortized over 15 years.



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## 10. Core deposit intangible asset

In conjunction with the 2012 acquisition mentioned in Note 10, the Corporation recorded a \$1.5 million core deposit intangible asset. The following sets forth the carrying amounts and accumulated amortization of core deposit intangible assets at March 31, 2014 and December 31, 2013:

|                               | 2014            |                             | 2013            |                             |
|-------------------------------|-----------------|-----------------------------|-----------------|-----------------------------|
|                               | Gross<br>Amount | Accumulated<br>Amortization | Gross<br>Amount | Accumulated<br>Amortization |
| Core deposit intangible asset | \$ 1,500,000    | \$ 536,184                  | \$ 1,500,000    | \$ 470,436                  |

There were no additions of acquired intangible assets during 2014 or 2013.

Amortization expense on core deposit intangible assets totaled \$65,748 and \$73,773 for the three months ended March 31, 2014 and 2013, respectively.

Estimated remaining amortization expense on core deposit intangible for the years ending is as follows:

|      |            |
|------|------------|
| 2014 | \$ 178,252 |
| 2015 | 217,500    |
| 2016 | 193,864    |
| 2017 | 172,768    |
| 2018 | 152,732    |
| 2019 | 48,700     |
|      | \$963,816  |

## 11. Subsequent Events

Management evaluated subsequent events through the date the financial statements were issued. On April 30, 2014, First National Bank, Ames, Iowa, a 100% owned subsidiary of Ames National Corporation, entered into a purchase and assumption agreement with another financial institution to purchase substantially all of the assets of the other institution, including loans, and assume substantially all of the liabilities of the other institution, including deposits. At closing, First National Bank expects to provide the seller with a payment of approximately \$4,700,000, adjusted for certain items at closing. The transaction is expected to close in the third quarter of 2014, subject to regulatory approval and other customary closing conditions. There were no other significant events or transactions occurring after March 31, 2014, but prior to May 8, 2014, that provided additional evidence about conditions that existed at March 31, 2014. There were no other significant events or transactions that provided evidence about conditions that did not exist at March 31, 2014.

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

## Overview

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

condition and results of operations.

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The Company does not engage in any material business activities apart from its ownership of the Banks. Products and services offered by the Banks are for commercial and consumer purposes including loans, deposits and trust services. The Banks also offer investment services through a third-party broker-dealer. The Company employs twelve individuals to assist with financial reporting, human resources, audit, compliance, marketing, technology systems and the coordination of management activities, in addition to 191 full-time equivalent individuals employed by the Banks.

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

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

On April 30, 2014, First National Bank, a 100% owned subsidiary of the Company, entered into a Purchase and Assumption Agreement (the "Purchase Agreement") with First Bank, an Iowa state chartered bank located in West Des Moines, Iowa. The Agreement provides for the purchase of substantially all of the assets, including loans, and the assumption of substantially all of the liabilities, including deposit accounts, of First Bank. All three bank offices currently operated by First Bank in West Des Moines, Iowa and Johnston, Iowa will become offices of First National Bank following the closing. At closing, First National will pay to First Bank approximately \$4,700,000, adjusted for First Bank's net income (loss) from January 1, 2014 through the acquisition date, as well as certain other items. The transaction is expected to close in the third quarter of 2014, subject to regulatory approval and other customary closing conditions. The Purchase Agreement contains standard seller representations and warranties and indemnification obligations to be secured by an escrow arrangement into which \$1.0 million of the purchase price payment will be deposited at closing. A copy of the Purchase Agreement has been filed as Exhibit 2 to this Report.

The Company had net income of \$4,526,000, or \$0.49 per share, for the three months ended March 31, 2014, compared to net income of \$3,586,000, or \$0.39 per share, for the three months ended March 31, 2013. Total equity capital as of March 31, 2014 totaled \$147.2 million or 11.7% of total assets.

The increase in quarterly earnings can be primarily attributed to an after tax gain on the sale of premises and equipment of \$788,000, increases in interest income on securities available-for-sale and loans, offset in part by a decrease in the level of gain realized on sale of loans held for sale. As had been anticipated and discussed in earlier filings, the Company completed the sale of its office location near Iowa State University in Ames, Iowa (University office), but the Company is evaluating different alternatives to locate an office near the campus. Excluding the one-time gain on the sale of premises and equipment, net income would have been \$3,738,000, or \$0.40 per share in 2014, as compared to \$3,586,000, or \$0.39 per share in 2013.

Net loan charge-offs totaled \$43,000 and \$400 for the three months ended March 31, 2014 and 2013, respectively. The provision for loan losses totaled \$39,000 and \$14,000 for the three months ended March 31, 2014 and 2013, respectively.

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

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

## Challenges

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

## Key Performance Indicators and Industry Results

Certain key performance indicators for the Company and the industry are presented in the following chart. The industry figures are compiled by the Federal Deposit Insurance Corporation (the "FDIC") and are derived from 6,812 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

|                     | Quarter<br>Ended<br>March<br>31,<br>2014<br>Company |   | Years Ended December 31,<br>2013<br>Company |   | Industry |   | 2012<br>Company |   | Industry |   | 2011<br>Company |   | Industry |   |
|---------------------|-----------------------------------------------------|---|---------------------------------------------|---|----------|---|-----------------|---|----------|---|-----------------|---|----------|---|
| Return on assets    | 1.45                                                | % | 1.14                                        | % | 1.07     | % | 1.24            | % | 1.00     | % | 1.38            | % | 0.88     | % |
| Return on equity    | 12.43                                               | % | 9.76                                        | % | 9.56     | % | 10.08           | % | 8.92     | % | 10.82           | % | 7.86     | % |
| Net interest margin | 3.24                                                | % | 3.18                                        | % | 3.26     | % | 3.35            | % | 3.42     | % | 3.60            | % | 3.60     | % |
| Efficiency ratio    | 45.63                                               | % | 52.78                                       | % | 60.54    | % | 52.33           | % | 61.60    | % | 49.80           | % | 61.37    | % |
| Capital ratio       | 11.69                                               | % | 11.67                                       | % | 9.41     | % | 12.31           | % | 9.15     | % | 12.75           | % | 9.09     | % |

\*Latest available data

Key performances indicators include:

- Return on Assets

This ratio is calculated by dividing net income by average assets. It is used to measure how effectively the assets of the Company are being utilized in generating income. The Company's annualized return on average assets was 1.45% and 1.18% for the three months ended March 31, 2014 and 2013, respectively. The increase in this ratio in 2014 from the previous period is primarily the result of the gain on the sale of the University office in 2014.

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### ·Return on Equity

This ratio is calculated by dividing net income by average equity. It is used to measure the net income or return the Company generated for the shareholders' equity investment in the Company. The Company's return on average equity was 12.43% and 9.87% for the three months ended March 31, 2014 and 2013, respectively. The increase in this ratio in 2014 from the previous period is primarily the result of the gain on the sale of the University office in 2014.

### ·Net Interest Margin

The net interest margin for the three months ended March 31, 2014 and 2013 was 3.24% and 3.13%, respectively. The ratio is calculated by dividing net interest income by average earning assets. Earning assets are primarily made up of loans and investments that earn interest. This ratio is used to measure how well the Company is able to maintain interest rates on earning assets above those of interest-bearing liabilities, which is the interest expense paid on deposits and other borrowings. The increase in this ratio in 2014 is primarily the result of higher interest earning average assets with increasing yields in the U.S. Government mortgage-backed securities portfolio.

### ·Efficiency Ratio

This ratio is calculated by dividing noninterest expense by net interest income and noninterest income. The ratio is a measure of the Company's ability to manage noninterest expenses. The Company's efficiency ratio was 45.63% and 51.56% for the three months ended March 31, 2014 and 2013, respectively. The change in the efficiency ratio in 2014 from the previous period is primarily the result of increased noninterest income.

### ·Capital Ratio

The average capital ratio is calculated by dividing average total equity capital by average total assets. It measures the level of average assets that are funded by shareholders' equity. Given an equal level of risk in the financial condition of two companies, the higher the capital ratio, generally the more financially sound the company. The Company's capital ratio of 11.69% as of March 31, 2014 is significantly higher than the industry average as of December 31, 2013.

## Industry Results

The FDIC Quarterly Banking Profile reported the following results for the fourth quarter of 2013:

### Lower Provision Expenses Exceed Decline in Revenues

Lower expenses for loan-loss provisions and a reduction in litigation reserves contributed to a \$5.8 billion (16.9%) year-over-year increase in quarterly net income at the nation's 6,812 insured commercial banks and savings institutions. Earnings improved despite a second consecutive year-over-year decline in quarterly revenues, caused in large part by reduced mortgage lending activity. A majority of institutions—53.1%—reported higher quarterly earnings than in fourth quarter 2012, while the percentage of institutions reporting quarterly losses fell to 12.2%, compared with 15% in the same quarter in 2012. The average return on assets (ROA) rose to 1.1%, from 0.96% a year ago.

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### Income From Mortgage Lending Remains Below Year-Ago Level

Net operating revenue—the sum of net interest income and total noninterest income—was \$2.8 billion (1.7%) lower than a year ago. Net interest income posted the first year-over-year increase in five quarters, rising by \$1.4 billion (1.3%), but noninterest income was \$4.2 billion (6.6%) less than banks reported in fourth quarter 2012. The decline in noninterest income reflected lower income from sale, securitization and servicing of 1-to-4 family residential mortgage loans (down \$2.8 billion, or 34.4% compared with a year ago), and reduced income from trading (down \$1.4 billion, or 32.2%). In addition to the decline in net operating revenue, realized securities gains were \$1 billion (66.6%) lower than a year ago. The year-over-year drop in revenue was offset by an \$8.1 billion (53.7%) reduction in loan-loss provisions, and a \$5.8 billion (5.3%) decline in noninterest expenses. Much of the reduction in noninterest expenses was attributable to a \$3.1 billion decline in litigation expenses at one large institution, but the industry's expenses for salaries and employee benefits were also \$756 million (1.6%) lower, and premises and fixed asset expenses fell by \$118 million (1%).

### Full-Year Earnings Post Fourth Consecutive Increase

For full year 2013, industry net income totaled \$154.7 billion, an increase of \$13.6 billion (9.6%) over 2012. This is the fourth year in a row that full-year earnings have risen. More than half of all institutions—54.2%—reported higher annual net income in 2013, while only 7.8% reported net losses for the full year. This is the lowest annual proportion of unprofitable institutions for the industry since 2005. Full-year loan-loss provisions of \$32.1 billion were \$25.7 billion (44.4%) less than banks set aside in 2012. This is the fourth year in a row that loan-loss provisions have been lower, and the total for 2013 was the smallest annual total since 2006. Net interest income declined for a third consecutive year, falling by \$3.7 billion (0.9%), as interest income fell more rapidly than interest expense. Noninterest income was \$3.2 billion (1.3%) above the level of 2012, as trading revenue increased by \$4.3 billion (23.7%), and servicing fee income rose by \$3.9 billion (27.5%). Realized gains on securities were \$5.2 billion (53.7%) lower than a year ago. Total noninterest expense was \$4.5 billion (1.1%) less. The average ROA for 2013 was 1.07%, the highest annual average for the industry since 2006.

### Loan Losses Fall to Seven-Year Low

Asset quality indicators continued to show improvement in the fourth quarter. Net charge-offs of loans and leases totaled \$11.7 billion, a \$6.8 billion (36.7%) decline from fourth quarter 2012. This is the 14th consecutive quarter that net charge-offs have posted a year-over-year decline, and is the lowest fourth-quarter total since 2006. Charge-offs were lower in all major loan categories, with the largest decline occurring in residential mortgages, where charge-offs were \$2.1 billion (57.7%) lower than a year ago.

### Noncurrent Balances Are Down 50% From Their Cyclical Peak

The amount of loans and leases that were noncurrent (90 days or more past due or in nonaccrual status) declined for a 15th consecutive quarter, falling by \$14 billion (6.3%). Noncurrent balances declined in all major loan groups, led by residential mortgages, where noncurrent loans fell by \$7.5 billion (5.3%). At the end of 2013, noncurrent loan balances totaled \$207.1 billion, which is \$202.9 billion (49.5%) below the peak level reached at the end of first quarter 2010. At year-end 2013, 2.62% of all loan and lease balances were noncurrent, the lowest percentage since third quarter 2008.



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### Coverage Improves Despite Reductions in Reserves

Insured institutions reduced their loan-loss reserves by \$6.7 billion (4.7%) during the fourth quarter, as the \$11.7 billion in net charge-offs taken out of reserves exceeded the \$7 billion in provisions that banks added to reserves. This is the 15th consecutive quarter that the industry's loss reserves have declined. At the end of the quarter, reserves represented 1.72% of total loans and leases, the lowest percentage since first quarter 2008. Despite the reduction in reserve balances, the industry's "coverage ratio" of reserves to noncurrent loans and leases rose from 64.5% to 65.6% during the quarter because of the large decline in noncurrent loans. This is the 5th consecutive quarter that the coverage ratio has risen.

### Banks Continue to Increase Capital Levels

Equity capital increased by \$21.3 billion (1.3%) during the quarter. Retained earnings contributed \$11.2 billion to equity, while capital infusions from parent holding companies added \$11.9 billion. A decline in market values of available-for-sale securities reduced equity growth by \$9 billion. Tier 1 leverage capital increased by \$23 billion (1.7%). The industry's core capital (leverage) ratio edged up from 9.4% to 9.41%, which is the highest level for this regulatory capital ratio in the 23 years that current capital standards have been in effect. At the end of 2013, almost 98% of all insured institutions, representing 99.8% of total industry assets, met or surpassed the highest regulatory capital standards as defined for Prompt Corrective Action purposes.

### Two-Thirds of Banks Report Growth in Loan Portfolios

Total assets increased by \$126.6 billion (0.9%), as loan portfolios grew for the 9th time in the past 11 quarters. Total loan and lease balances increased by \$90.9 billion (1.2%), with commercial and industrial (C&I) loans rising by \$27.3 billion (1.7%), real estate loans secured by nonfarm nonresidential properties up by \$17.1 billion (1.6%), and credit card balances posting a seasonal \$14.3 billion (2.1%) increase. Loans to small businesses and farms rose by \$2.9 billion (0.4%), as small C&I loans increased by \$3 billion (1%). Home equity loan balances declined for a 19th consecutive quarter, falling by \$6.9 billion (1.3%). Balances of other loans secured by 1-to-4 family residential real estate properties fell by \$13 billion (0.7%), as the amount of mortgage loans sold during the quarter surpassed the amount originated for sale by \$29 billion. Nearly two out of every three banks (65.1%) reported growth in their loan portfolios during the quarter. Securities portfolios increased by \$44.3 billion (1.5%), despite a \$14.5 billion decline in the fair value of securities in available-for-sale accounts. Much of the growth consisted of increased holdings of U.S. Treasury securities, which rose by \$33 billion (20.6%).

### Deposit Growth Remains Strong

Increased balances in large-denomination accounts were responsible for much of the growth in deposits in the fourth quarter. Total deposits increased by \$163.8 billion (1.5%), as balances in domestic offices rose by \$191.3 billion and foreign office balances fell by \$27.4 billion. Deposits in domestic accounts with balances greater than \$250,000 rose by \$166 billion (3.5%). Nondeposit liabilities fell by \$55.1 billion (2.9%), largely because of a \$42 billion (12.1%) decline in securities sold under repurchase agreements. Banks increased their advances from Federal Home Loan Banks by \$33.1 billion (8.9%).

### Quarterly Banking Profile Failures Fall to Lowest Level in More Than Five Years

The number of insured institutions reporting financial results declined from 6,891 to 6,812 during the fourth quarter. Mergers absorbed 73 institutions, while two insured institutions failed. This is the smallest number of quarterly failures since second quarter 2008. One new reporter was added during the quarter, the first de novo charter since fourth quarter 2010. The number of institutions on the FDIC's "Problem List" declined from 515 to 467 during the quarter. Total assets of "problem" banks fell from \$174.2 billion to \$152.7 billion. The number of full-time equivalent

employees declined by 11,584 (0.6%) during the quarter. For all of 2013, the net reduction in reporting institutions was 271. There were 232 mergers during the year, while 24 insured institutions failed. Two new reporters were added in 2013. For the full year, the number of employees declined by 41,490 (2%).

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Critical Accounting Policies

The discussion contained in this Item 2 and other disclosures included within this report are based, in part, on the Company's audited December 31, 2013 consolidated financial statements. These statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The financial information contained in these statements is, for the most part, based on the financial effects of transactions and events that have already occurred. However, the preparation of these statements requires management to make certain estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses.

The Company's significant accounting policies are described in the "Notes to Consolidated Financial Statements" contained in the Company's Annual Report. Based on its consideration of accounting policies that involve the most complex and subjective estimates and judgments, management has identified its most critical accounting policies to be those related to the allowance for loan losses, valuation of other real estate owned, the assessment of other-than-temporary impairment of certain securities available-for-sale and the valuation of goodwill.

Allowance for Loan Losses

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

Other Real Estate Owned

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

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

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

Goodwill

Goodwill arose in connection with an acquisition. These assets are tested annually for impairment or more often if conditions indicate a possible impairment. For the purposes of goodwill impairment testing, determination of the fair value of a reporting unit involves the use of significant estimates and assumptions. Through March 31, 2014, no conditions indicated impairment has incurred. The next annual test will be performed in the fourth quarter of 2014. Actual future test results may differ from the present evaluation of impairment due to changes in the conditions used at the time of that evaluation.

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## Income Statement Review for the Three Months ended March 31, 2014

The following highlights a comparative discussion of the major components of net income and their impact for the three months ended March 31, 2014 and 2013:

## AVERAGE BALANCES AND INTEREST RATES

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

## AVERAGE BALANCE SHEETS AND INTEREST RATES

|                                                             | Three Months ended March 31, |                     |                |                    |                     |                |
|-------------------------------------------------------------|------------------------------|---------------------|----------------|--------------------|---------------------|----------------|
|                                                             | 2014                         |                     |                | 2013               |                     |                |
|                                                             | Average<br>balance           | Revenue/<br>expense | Yield/<br>rate | Average<br>balance | Revenue/<br>expense | Yield/<br>rate |
| <b>ASSETS</b>                                               |                              |                     |                |                    |                     |                |
| (dollars in thousands)                                      |                              |                     |                |                    |                     |                |
| Interest-earning assets                                     |                              |                     |                |                    |                     |                |
| Loans <sup>1</sup>                                          |                              |                     |                |                    |                     |                |
| Commercial                                                  | \$83,388                     | \$959               | 4.60 %         | \$79,983           | \$938               | 4.69 %         |
| Agricultural                                                | 72,178                       | 871                 | 4.83 %         | 66,646             | 904                 | 5.42 %         |
| Real estate                                                 | 390,850                      | 4,396               | 4.50 %         | 347,848            | 4,109               | 4.73 %         |
| Consumer and other                                          | 12,779                       | 185                 | 5.79 %         | 15,560             | 207                 | 5.33 %         |
| Total loans (including fees)                                | 559,195                      | 6,411               | 4.59 %         | 510,037            | 6,158               | 4.83 %         |
| Investment securities                                       |                              |                     |                |                    |                     |                |
| Taxable                                                     | 293,804                      | 1,763               | 2.40 %         | 293,991            | 1,380               | 1.88 %         |
| Tax-exempt <sup>2</sup>                                     | 295,074                      | 2,574               | 3.49 %         | 286,326            | 2,658               | 3.71 %         |
| Total investment securities                                 | 588,878                      | 4,337               | 2.95 %         | 580,317            | 4,038               | 2.78 %         |
| Interest bearing deposits with banks and federal funds sold |                              |                     |                |                    |                     |                |
|                                                             | 41,782                       | 73                  | 0.70 %         | 60,569             | 110                 | 0.72 %         |
| Total interest-earning assets                               | 1,189,855                    | \$10,821            | 3.64 %         | 1,150,923          | \$10,306            | 3.58 %         |
| Noninterest-earning assets                                  | 55,326                       |                     |                | 69,055             |                     |                |
| TOTAL ASSETS                                                | \$1,245,181                  |                     |                | \$1,219,978        |                     |                |

<sup>1</sup> Average loan balance includes nonaccrual loans, if any. Interest income collected on nonaccrual loans has been included.

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



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## AVERAGE BALANCE SHEETS AND INTEREST RATES

|                                                   | Three Months ended March 31, |                     |                |                    |                     |                |
|---------------------------------------------------|------------------------------|---------------------|----------------|--------------------|---------------------|----------------|
|                                                   | 2014                         |                     |                | 2013               |                     |                |
|                                                   | Average<br>balance           | Revenue/<br>expense | Yield/<br>rate | Average<br>balance | Revenue/<br>expense | Yield/<br>rate |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>       |                              |                     |                |                    |                     |                |
| (dollars in thousands)                            |                              |                     |                |                    |                     |                |
| Interest-bearing liabilities                      |                              |                     |                |                    |                     |                |
| Deposits                                          |                              |                     |                |                    |                     |                |
| NOW, savings accounts and money markets           | \$612,752                    | \$ 296              | 0.19 %         | \$582,405          | \$ 287              | 0.20 %         |
| Time deposits > \$100,000                         | 96,000                       | 245                 | 1.02 %         | 99,324             | 281                 | 1.13 %         |
| Time deposits < \$100,000                         | 144,045                      | 351                 | 0.98 %         | 154,261            | 428                 | 1.11 %         |
| Total deposits                                    | 852,797                      | 892                 | 0.42 %         | 835,990            | 996                 | 0.48 %         |
| Other borrowed funds                              | 71,490                       | 294                 | 1.65 %         | 65,512             | 296                 | 1.81 %         |
| Total Interest-bearing liabilities                | 924,287                      | 1,186               | 0.51 %         | 901,502            | 1,292               | 0.57 %         |
| Noninterest-bearing liabilities                   |                              |                     |                |                    |                     |                |
| Demand deposits                                   | 169,427                      |                     |                | 165,766            |                     |                |
| Other liabilities                                 | 5,869                        |                     |                | 7,426              |                     |                |
| Stockholders' equity                              | 145,598                      |                     |                | 145,284            |                     |                |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$1,245,181</b>           |                     |                | <b>\$1,219,978</b> |                     |                |
|                                                   |                              |                     |                |                    |                     |                |
| Net interest income                               |                              | \$ 9,635            | 3.24 %         |                    | \$ 9,014            | 3.13 %         |
| Spread Analysis                                   |                              |                     |                |                    |                     |                |
| Interest income/average assets                    | \$10,821                     | 3.48 %              |                | \$10,306           | 3.38 %              |                |
| Interest expense/average assets                   | \$1,186                      | 0.38 %              |                | \$1,292            | 0.42 %              |                |
| Net interest income/average assets                | \$9,635                      | 3.10 %              |                | \$9,014            | 2.96 %              |                |

## Net Interest Income

For the three months ended March 31, 2014 and 2013, the Company's net interest margin adjusted for tax exempt income was 3.24% and 3.13%, respectively. Net interest income, prior to the adjustment for tax-exempt income, for the three months ended March 31, 2014 totaled \$8,734,000 compared to \$8,085,000 for the three months ended March 31, 2013.

For the three months ended March 31, 2014, interest income increased \$544,000, or 5.8%, when compared to the same period in 2013. The increase from 2013 was primarily attributable higher average balance of loans and higher average yields on securities available-for-sale, offset in part by lower average yields on loans. The higher average balances were due primarily to increased loan demand. The higher yield on securities available-for-sale is due primarily to the slowdown in the payments received on U.S. Government mortgage-backed securities. The lower

yields on loans were due primarily to the repricing of loans into lower market interest rates.



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Interest expense decreased \$105,000, or 8.2%, for the three months ended March 31, 2014 when compared to the same period in 2013. The lower interest expense for the period is primarily attributable to lower average rates paid on time deposits and a decrease in the average balance of time deposits. The lower yields were due primarily to continued low market interest rates.

## Provision for Loan Losses

The Company's provision for loan losses was \$39,000 and \$14,000 for the three months ended March 31, 2014 and 2013, respectively. Net loan charge-offs were \$43,000 and \$400 for the three months ended March 31, 2014 and 2013, respectively.

## Noninterest Income and Expense

Noninterest income increased \$1,103,000 or 59.8% for the three months ended March 31, 2014 compared to the same period in 2013. The increase in noninterest income is primarily due to the gain on the sale of the University office, which was offset in part by a decrease in the level of gain realized on the sale of loans held for sale due to decreased secondary market volume as refinancing activity has slowed. Excluding net security gains and the gain on the sale of the University office, non-interest income decreased \$220,000, or 12.4%.

Noninterest expense increased \$210,000 or 4.1% for the three months ended March 31, 2014 compared to the same period in 2013 primarily as a result of increased occupancy expense due to one-time costs associated with the sale of the University office and increased salaries and benefits due to normal salary increases.

## Income Taxes

The provision for income taxes expense for the three months ended March 31, 2014 and 2013 was \$1,785,000 and \$1,209,000, representing an effective tax rate of 28% and 25%, respectively. The increase in the effective rate is due primarily to impact of the one-time gain on the sale of the University office

## Balance Sheet Review

As of March 31, 2014, total assets were \$1,257,981,000, a \$24,897,000 increase compared to December 31, 2013. The increase assets were primarily due to an increase in interest bearing deposits in financial institutions and securities available-for-sale, offset in part by a decrease in loans. This increase in assets was funded primarily by an increase in deposits.

## Investment Portfolio

The investment portfolio totaled \$600,831,000 as of March 31, 2014, an increase of \$20,792,000 or 3.6% from the December 31, 2013 balance of \$580,039,000. The increase in the investment portfolio was primarily due to an increase in U.S. government agencies portfolio.

On a quarterly basis, the investment portfolio is reviewed for other-than-temporary impairment. As of March 31, 2014, gross unrealized losses of \$6,049,000, are considered to be temporary in nature due to the increasing interest rate environment of 2014 and other general economic factors. As a result of the Company's favorable liquidity position, the Company does not have the intent to sell securities with an unrealized loss at the present time. In addition, management believes it is more likely than not that the Company will hold these securities until recovery of their fair value to cost basis and avoid considering present unrealized loss positions to be other-than-temporary.



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At March 31, 2014, the Company's investment securities portfolio included securities issued by 320 government municipalities and agencies located within 26 states with a fair value of \$314.2 million. At December 31, 2013, the Company's investment securities portfolio included securities issued by 315 government municipalities and agencies located within 25 states with a fair value of \$315.2 million. No one municipality or agency represents a concentration within this segment of the investment portfolio. The largest exposure to any one municipality or agency was \$5.4 million (approximately 1.7% of the fair value of the governmental municipalities and agencies) represented by the Urbandale, Iowa Community School District to be repaid by sales tax revenues and property taxes.

The Company's procedures for evaluating investments in states, municipalities and political subdivisions include but are not limited to reviewing the offering statement and the most current available financial information, comparing yields to yields of bonds of similar credit quality, confirming capacity to repay, assessing operating and financial performance, evaluating the stability of tax revenues, considering debt profiles and local demographics, and for revenue bonds, assessing the source and strength of revenue structures for municipal authorities. These procedures, as applicable, are utilized for all municipal purchases and are utilized in whole or in part for monitoring the portfolio of municipal holdings. The Company does not utilize third party credit rating agencies as a primary component of determining if the municipal issuer has an adequate capacity to meet the financial commitments under the security for the projected life of the investment, and, therefore, does not compare internal assessments to those of the credit rating agencies. Credit rating downgrades are utilized as an additional indicator of credit weakness and as a reference point for historical default rates.

The following table summarizes the total general obligation and revenue bonds in the Company's investment securities portfolios as of March 31, 2014 and December 31, 2013 identifying the state in which the issuing government municipality or agency operates.

|                                                        | At March 31, 2014 |               | At December 31, 2013 |               |
|--------------------------------------------------------|-------------------|---------------|----------------------|---------------|
|                                                        | Amortized<br>Cost | Fair<br>Value | Amortized<br>Cost    | Fair<br>Value |
| Obligations of states and political subdivisions:      |                   |               |                      |               |
| General Obligation bonds:                              |                   |               |                      |               |
| Iowa                                                   | \$89,071,741      | \$90,026,342  | \$89,366,543         | \$90,185,483  |
| Texas                                                  | 12,128,149        | 12,316,320    | 12,157,710           | 12,194,442    |
| Minnesota                                              | 9,407,578         | 9,549,033     | 10,675,196           | 10,822,010    |
| Other (2014: 18 states; 2013: 18 states)               | 42,664,429        | 42,987,082    | 44,177,157           | 44,378,914    |
| Total general obligation bonds                         | \$153,271,897     | \$154,878,777 | \$156,376,606        | \$157,580,849 |
| Revenue bonds:                                         |                   |               |                      |               |
| Iowa                                                   | \$148,797,943     | \$149,666,831 | \$147,961,627        | \$147,879,830 |
| Other (2014: 11 states; 2013: 10 states)               | 9,647,471         | 9,630,823     | 9,839,225            | 9,763,454     |
| Total revenue bonds                                    | \$158,445,414     | \$159,297,654 | \$157,800,852        | \$157,643,284 |
| Total obligations of states and political subdivisions | \$311,717,311     | \$314,176,431 | \$314,177,458        | \$315,224,133 |

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As of March 31, 2014 and December 31, 2013, the revenue bonds in the Company's investment securities portfolios were issued by government municipalities and agencies to fund public services such as community school facilities, college and university dormitory facilities, water utilities and electrical utilities. The revenue bonds are to be paid from 9 revenue sources. The revenue sources that represent 5% or more, individually, as a percent of the total revenue bonds are summarized in the following table.

|                                                        | At March 31, 2014 |               | At December 31, 2013 |               |
|--------------------------------------------------------|-------------------|---------------|----------------------|---------------|
|                                                        | Amortized Cost    | Fair Value    | Amortized Cost       | Fair Value    |
| Revenue bonds by revenue source                        |                   |               |                      |               |
| Sales tax                                              | \$92,393,142      | \$93,416,681  | \$92,533,182         | \$92,904,707  |
| College and universities, primarily dormitory revenues | 15,602,204        | 15,474,559    | 15,608,810           | 15,340,745    |
| Water                                                  | 13,628,045        | 13,479,642    | 13,263,506           | 12,988,423    |
| Leases                                                 | 9,936,491         | 9,783,764     | 10,202,006           | 9,977,022     |
| Electric                                               | 6,832,973         | 6,993,527     | 5,950,969            | 6,091,440     |
| Other                                                  | 20,052,559        | 20,149,481    | 20,242,379           | 20,340,947    |
| Total revenue bonds by revenue source                  | \$158,445,414     | \$159,297,654 | \$157,800,852        | \$157,643,284 |

## Loan Portfolio

The loan portfolio, net of the allowance for loan losses of \$8,568,000, totaled \$548,545,000 as of March 31, 2014, a decrease of \$15,956,000, or 2.8%, from the December 31, 2013 balance of \$564,502,000. The decrease in the loan portfolio is primarily due to a decrease in the agricultural operating loan portfolio and to a lesser extent the commercial operating and commercial real estate loan portfolios. The decline in the agricultural operating loan portfolio is due primarily to agricultural customers seasonal borrowing needs.

## Deposits

Deposits totaled \$1,027,793,000 as of March 31, 2014, an increase of \$15,990,000, or 1.6%, from the December 31, 2013 balance of \$1,011,803,000. The increase in deposits occurred primarily in money market accounts, offset in part by decreases in commercial demand deposit account and time deposits.

## Securities Sold Under Agreements to Repurchase and Federal Funds Purchased

Securities sold under agreements to repurchase and federal funds purchased totaled \$39,910,000 as of March 31, 2014, an increase of \$294,000, or 0.7%, from the December 31, 2013 balance of \$39,617,000.

## FHLB Advances and Other Long-Term Borrowings

FHLB advances and other long-term borrowings totaled \$36,723,000 and \$34,541,000 as of March 31, 2014 and December 31, 2013, respectively. During the three months ended March 31, 2014, the increase in FHLB advances and other long-term borrowings are due primarily to overnight borrowing from the FHLB of \$2,200,000.

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Off-Balance Sheet Arrangements

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. No material changes in the Company's off-balance sheet arrangements have occurred since December 31, 2013.

Asset Quality Review and Credit Risk Management

The Company's credit risk is historically centered in the loan portfolio, which on March 31, 2014 totaled \$548,545,000 compared to \$564,502,000 as of December 31, 2013. Net loans comprise 43.7% of total assets as of March 31, 2014. The object in managing loan portfolio risk is to reduce the risk of loss resulting from a customer's failure to perform according to the terms of a transaction and to quantify and manage credit risk on a portfolio basis. The Company's level of problem loans (consisting of nonaccrual loans and loans past due 90 days or more) as a percentage of total loans was 0.34% at March 31, 2014, as compared to 0.44% at December 31, 2013 and 1.08% at March 31, 2013. The Company's level of problem loans as a percentage of total loans at March 31, 2014 of 0.34% is lower than the Company's peer group (344 bank holding companies with assets of \$1 billion to \$3 billion) of 1.46% as of December 31, 2013.

Impaired loans, net of specific reserves, totaled \$1,434,000 as of March 31, 2014 and were lower than impaired loans of \$2,244,000 as of December 31, 2013 and \$5,965,000 as of March 31, 2013. The decrease in impaired loans from December 31, 2013 is due primarily to payments received and credit improvements on impaired loans during the three months ended March 31, 2014.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payment of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. The Company applies its normal loan review procedures to identify loans that should be evaluated for impairment.

The Company had TDRs of \$1,223,000 as of March 31, 2014, of which all were included in impaired loans and on nonaccrual status. The Company had TDRs of \$1,424,000 as of December 31, 2013, all of which were included in impaired loans and \$1,237,000 were on nonaccrual status and \$187,000 were included on accrual status.

TDRs are monitored and reported on a quarterly basis. Certain TDRs are on nonaccrual status at the time of restructuring. These borrowings are typically returned to accrual status after the following: sustained repayment performance in accordance with the restructuring agreement for a reasonable period of at least six months; and, management is reasonably assured of future performance. If the TDR meets these performance criteria and the interest rate granted at the modification is equal to or greater than the rate that the Company was willing to accept at the time of the restructuring for a new loan with comparable risk, then the loan will return to performing status.

For TDRs that were on nonaccrual status before the modification, a specific reserve may already be recorded. In periods subsequent to modification, the Company will continue to evaluate all TDRs for possible impairment and, as necessary, recognizes impairment through the allowance. The Company had one charge-off related to TDRs for the three months ended March 31, 2014 in the amount of \$44,000 and no charge-offs for the three months ended March 31, 2013.

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Loans past due 90 days or more that are still accruing interest are reviewed no less frequently than quarterly to determine if there is a strong reason that the credit should not be placed on non-accrual. As of March 31, 2014, non-accrual loans totaled \$1,880,000; there were no loans past due 90 days and still accruing. This compares to non-accrual loans of \$2,508,000 and \$27,000 loans past due 90 days and still accruing as of December 31, 2013. Other real estate owned totaled \$8,880,000 as of March 31, 2014 and \$8,861,000 as of December 31, 2013.

The allowance for loan losses as a percentage of outstanding loans as of March 31, 2014 and December 31, 2013 was 1.54% and 1.50%, respectively. The allowance for loan losses totaled \$8,568,000 and \$8,572,000 as of March 31, 2014 and December 31, 2013, respectively. Net charge-offs of loans totaled \$43,000 and \$400 for the three months ended March 31, 2014 and 2013, respectively.

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

## Liquidity and Capital Resources

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

Liquidity is derived primarily from core deposit growth and retention; principal and interest payments on loans; principal and interest payments, sale, maturity and prepayment of securities available-for-sale; net cash provided from operations; and access to other funding sources. Other funding sources include federal funds purchased lines, FHLB advances and other capital market sources.

As of March 31, 2014, the level of liquidity and capital resources of the Company remain at a satisfactory level. Management believes that the Company's liquidity sources will be sufficient to support its existing operations for the foreseeable future.

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

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

Review of the Company's Current Liquidity Sources

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Liquid assets of cash and due from banks and interest-bearing deposits in financial institutions as of March 31, 2014 and December 31, 2013 totaled \$70,777,000 and \$47,898,000, respectively, and provide a level of liquidity.

Other sources of liquidity available to the Banks as of March 31, 2014 include outstanding lines of credit with the Federal Home Loan Bank of Des Moines, Iowa of \$124,886,000, with \$16,723,000 of outstanding FHLB advances at March 31, 2014. Federal funds borrowing capacity at correspondent banks was \$95,972,000, with no outstanding federal fund balances as of March 31, 2014. The Company had securities sold under agreements to repurchase totaling \$39,910,000 and long-term repurchase agreements of \$20,000,000 as of March 31, 2014.

Total investments as of March 31, 2014 were \$600,831,000 compared to \$580,039,000 as of December 31, 2013. These investments provide the Company with a significant amount of liquidity since all of the investments are classified as available-for-sale as of March 31, 2014.

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

## Review of Statements of Cash Flows

Net cash provided by operating activities for the three months ended March 31, 2014 totaled \$6,507,000 compared to the \$6,177,000 for the three months ended March 31, 2013. The increase of \$331,000 in net cash provided by operating activities was primarily due to an increase in net income, deferred income taxes and loans held for sale, offset in part by a decrease in amortization and the gain on the sale of premises and equipment.

Net cash used in investing activities for the three months ended March 31, 2014 was \$17,382,000 and compares to \$52,059,000 for the three months ended March 31, 2013. The decrease of \$34,677,000 in net cash used in investing activities was primarily due to changes in securities available-for-sale, interest bearing deposits in financial institutions and loans.

Net cash provided by financing activities for the three months ended March 31, 2014 totaled \$17,014,000 compared to \$33,772,000 for the three months ended March 31, 2013. The decrease of \$16,758,000 in net cash provided by financing activities was primarily due to changes in deposits and securities sold under agreements to repurchase. As of March 31, 2014, the Company did not have any external debt financing, off-balance sheet financing arrangements, or derivative instruments linked to its stock.

## Company Only Cash Flows

The Company's liquidity on an unconsolidated basis is heavily dependent upon dividends paid to the Company by the Banks. The Company requires adequate liquidity to pay its expenses and pay stockholder dividends. For the three months ended March 31, 2014, dividends paid by the Banks to the Company amounted to \$1,900,000 compared to \$1,800,000 for the same period in 2013. Various federal and state statutory provisions limit the amounts of dividends banking subsidiaries are permitted to pay to their holding companies without regulatory approval. Federal Reserve policy further limits the circumstances under which bank holding companies may declare dividends. For example, a bank holding company should not continue its existing rate of cash dividends on its common stock unless its net income is sufficient to fully fund each dividend and its prospective rate of earnings retention appears consistent with its capital needs, asset quality and overall financial condition. In addition, the Federal Reserve and the FDIC have issued policy statements, which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings. Federal and state banking regulators may also restrict the payment of dividends by order. The quarterly dividend declared by the Company increased to \$0.18 per share in 2014 from

\$0.16 per share in 2013.

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The Company, on an unconsolidated basis, has interest bearing deposits and marketable investment securities totaling \$10,243,000 as of March 31, 2014 that are presently available to provide additional liquidity to the Banks.

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

As noted above, First National and First Bank have entered into the Purchase Agreement under which First National will purchase from First Bank substantially all its assets, including loans, and assume substantially all its liabilities, including deposit accounts. At closing, First National will pay First Bank approximately \$4.7 million, adjusted by First Bank's net income (loss) from January 1, 2014 through the acquisition date, as well as certain other items. The Company expects to fund the purchase price from cash reserves held at First National and does not anticipate that any third-party financing will be required to consummate the transaction.

No other material capital expenditures or material changes in the capital resource mix are anticipated at this time. The primary cash flow uncertainty would be a sudden decline in deposits causing the Banks to liquidate securities. Historically, the Banks have maintained an adequate level of short-term marketable investments to fund the temporary declines in deposit balances. There are no known trends in liquidity and cash flow needs as of March 31, 2014 that are of concern to management.

Capital Resources

The Company's total stockholders' equity as of March 31, 2014 totaled \$147,188,000 and was higher than the \$142,106,000 recorded as of December 31, 2013. The increase in stockholders' equity was primarily due to net income, reduced by dividends and an increase in accumulated other comprehensive income. The increase in other comprehensive income is created by 2014 market interest rates trending lower, which resulted in higher fair values in the securities available-for-sale portfolio. At March 31, 2014 and December 31, 2013, stockholders' equity as a percentage of total assets was 11.70% and 11.52%, respectively. The capital levels of the Company exceed applicable regulatory guidelines as of March 31, 2014.

In early July 2013, the Federal Reserve Board and the FDIC issued interim final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The interim final rule revises the regulatory capital elements, adds a new common equity Tier I capital ratio, and increases the minimum Tier I capital ratio requirement. The revisions also permit banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income and implement a new capital conservation buffer. The final rule will become effective January 1, 2015, subject to a transition period. Management is in the process of assessing the effect the Basel III Rules may have on the Company's and the Bank's capital positions and will monitor developments in this area.

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### Forward-Looking Statements and Business Risks

The Private Securities Litigation Reform Act of 1995 provides the Company with the opportunity to make cautionary statements regarding forward-looking statements contained in this Quarterly Report, including forward-looking statements concerning the Company's future financial performance and asset quality. Any forward-looking statement contained in this Quarterly Report is based on management's current beliefs, assumptions and expectations of the Company's future performance, taking into account all information currently available to management. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to management. If a change occurs, the Company's business, financial condition, liquidity, results of operations, asset quality, plans and objectives may vary materially from those expressed in the forward-looking statements. The risks and uncertainties that may affect the actual results of the Company include, but are not limited to, the following: economic conditions, particularly in the concentrated geographic area in which the Company and its affiliate banks operate; competitive products and pricing available in the marketplace; changes in credit and other risks posed by the Company's loan and investment portfolios, including declines in commercial or residential real estate values or changes in the allowance for loan losses dictated by new market conditions or regulatory requirements; fiscal and monetary policies of the U.S. government; changes in governmental regulations affecting financial institutions (including regulatory fees and capital requirements); changes in prevailing interest rates; credit risk management and asset/liability management; the financial and securities markets; the availability of and cost associated with sources of liquidity; the Company's ability to successfully integrate the assets being purchased from First Bank into its operations on a timely and cost effective basis; and other risks and uncertainties inherent in the Company's business, including those discussed under the headings "Risk Factors" and "Forward-Looking Statements and Business Risks" in the Company's Annual Report. Management intends to identify forward-looking statements when using words such as "believe", "expect", "intend", "anticipate", "estimate", "should" or similar expressions. Undue reliance should not be placed on these forward-looking statements. The Company undertakes no obligation to revise or update such forward-looking statements to reflect current events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's market risk is comprised primarily of interest rate risk arising from its core banking activities of lending and deposit taking. Interest rate risk results from the changes in market interest rates which may adversely affect the Company's net interest income. Management continually develops and applies strategies to mitigate this risk. Management does not believe that the Company's primary market risk exposure and how it has been managed year-to-date in 2014 changed significantly when compared to 2013.

### Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of the Company's management, including the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended). Based on that evaluation, the Company's management, including the Principal Executive Officer and Principal Financial Officer, concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

There was no change in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.



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## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

Not applicable

## Item 1.A. Risk Factors

None.

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

In November, 2013, the Company approved a Stock Repurchase Plan which provided for the repurchase of up to 100,000 shares of the Company's common stock. As of March 31, 2014, there were 100,000 shares remaining to be purchased under the plan.

The following table provides information with respect to purchase made by or on behalf of the Company or any "affiliated purchases" (as defined in rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of the Company's common stock during the three months ended March 31, 2014.

| Period                                | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid<br>Per<br>Share | Total<br>Number<br>of Shares<br>Purchased<br>as<br>Part of<br>Publicly<br>Announced<br>Plans | Maximum<br>Number<br>of<br>Shares<br>that<br>May Yet<br>Be<br>Purchased<br>Under<br>The Plan |
|---------------------------------------|-------------------------------------------|------------------------------------------|----------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------|
| January 1, 2014 to January 31, 2014   | -                                         | \$ -                                     | -                                                                                            | 100,000                                                                                      |
| February 1, 2014 to February 28, 2014 | -                                         | \$ -                                     | -                                                                                            | 100,000                                                                                      |
| March 1, 2014 to March 31, 2014       | -                                         | \$ -                                     | -                                                                                            | 100,000                                                                                      |
| Total                                 | -                                         |                                          | -                                                                                            |                                                                                              |

## Item 3. Defaults Upon Senior Securities

Not applicable

## Item 4. Mine Safety Disclosures

Not applicable



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Item 5. Other information

Not applicable

Item 6. Exhibits

2 Purchase and Assumption Agreement, dated April 30, 2014, between First National Bank, Ames, Iowa and First Bank.

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

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

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

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

101.INS XBRL Instance Document (1)

101.SCH XBRL Taxonomy Extension Schema Document (1)

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document (1)

101.LAB XBRL Taxonomy Extension Label Linkbase Document (1)

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document (1)

101.DEF XBRL Taxonomy Extension Definition Linkbase Document (1)

(1) These interactive data files shall not be deemed filed for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.

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SIGNATURES

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

AMES NATIONAL CORPORATION

DATE: May 8, 2014 By: /s/ Thomas H. Pohlman

Thomas H. Pohlman, Chief Executive Officer and President

By: /s/ John P. Nelson

John P. Nelson, Chief Financial Officer and Vice President

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EXHIBIT INDEX

The following exhibits are filed herewith:

Exhibit No. Description

|             |                                                                                                                  |
|-------------|------------------------------------------------------------------------------------------------------------------|
| <u>2</u>    | Purchase and Assumption Agreement, dated April 30, 2014, between First National Bank, Ames, Iowa and First Bank. |
| <u>31.1</u> | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002           |
| <u>31.2</u> | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002           |
| <u>32.1</u> | Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350                                  |
| <u>32.2</u> | Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350                                  |
| 101.INS     | XBRL Instance Document (1)                                                                                       |
| 101.SCH     | XBRL Taxonomy Extension Schema Document (1)                                                                      |
| 101.CAL     | XBRL Taxonomy Extension Calculation Linkbase Document (1)                                                        |
| 101.LAB     | XBRL Taxonomy Extension Label Linkbase Document (1)                                                              |
| 101.PRE     | XBRL Taxonomy Extension Presentation Linkbase Document (1)                                                       |
| 101.DEF     | XBRL Taxonomy Extension Definition Linkbase Document (1)                                                         |

(1)These interactive data files shall not be deemed filed for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.