

AMES NATIONAL CORP  
Form 10-Q  
November 09, 2006

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**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

[Mark One]

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

For the quarterly period ended September 30, 2006

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

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

Commission File Number 0-32637

**AMES NATIONAL CORPORATION**

(Exact Name of Registrant as Specified in Its Charter)

**IOWA**

(State or Other Jurisdiction of Incorporation or Organization)

**42-1039071**

(I. R. S. Employer Identification Number)

**405 FIFTH STREET**

**AMES, IOWA 50010**

(Address of Principal Executive Offices)

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

**NOT APPLICABLE**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):  
Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

-- No x

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

**COMMON STOCK, \$2.00 PAR VALUE**

(Class)

**9,425,013**

(Shares Outstanding at November 1, 2006)

AMES NATIONAL CORPORATION

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Index**AMES NATIONAL CORPORATION AND SUBSIDIARIES****Consolidated Balance Sheets  
(unaudited)**

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
<b>ASSETS</b>		
Cash and due from banks	\$ 18,014,733	\$ 18,092,139
Federal funds sold	50,000	300,000
Interest bearing deposits in financial institutions	3,331,089	5,983,542
Securities available-for-sale	351,928,869	333,510,152
Loans receivable, net	424,848,430	440,317,685
Loans held for sale	591,185	981,280
Bank premises and equipment, net	11,913,843	11,030,840
Accrued income receivable	8,328,348	6,633,795
Deferred income taxes	-	343,989
Other assets	2,895,230	2,190,652
<b>Total assets</b>	<b>\$ 821,901,727</b>	<b>\$ 819,384,074</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Deposits		
Demand, noninterest bearing	\$ 73,742,114	\$ 74,155,477
NOW accounts	150,119,248	151,680,984
Savings and money market	149,674,765	160,998,014
Time, \$100,000 and over	92,706,421	101,042,024
Other time	183,418,287	180,465,836
<b>Total deposits</b>	<b>649,660,835</b>	<b>668,342,335</b>
Federal funds purchased and securities sold under agreements to repurchase	49,069,784	34,659,983
Other short-term borrowings	2,272,894	2,861,130
FHLB term advances	2,000,000	-
Dividend payable	2,450,503	2,354,818
Deferred income taxes	717,188	-
Accrued expenses and other liabilities	3,954,891	1,938,507
<b>Total liabilities</b>	<b>710,126,095</b>	<b>710,156,773</b>
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, \$2 par value, authorized 18,000,000 shares; 9,425,013 shares issued and outstanding September 30, 2006 and 9,419,271 shares issued and outstanding December 31, 2005	18,850,026	18,838,542
Additional paid-in capital	22,498,904	22,383,375
Retained earnings	65,586,270	64,713,530
Accumulated other comprehensive income, net unrealized gain on securities available-for-sale	4,840,432	3,291,854
<b>Total stockholders' equity</b>	<b>111,775,632</b>	<b>109,227,301</b>

<b>Total liabilities and stockholders' equity</b>	\$	821,901,727	\$	819,384,074
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(unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Interest and dividend income:				
Loans	\$ 7,504,606	\$ 7,036,222	\$ 22,064,447	\$ 19,888,720
Securities				
Taxable	2,320,638	2,121,380	6,488,712	6,469,383
Tax-exempt	1,045,124	1,040,237	3,121,681	3,162,676
Federal funds sold	40,918	3,277	144,911	131,557
Dividends	353,659	333,722	1,052,437	1,053,311
Total interest income	11,264,945	10,534,838	32,872,188	30,705,647
Interest expense:				
Deposits	5,111,121	3,691,821	14,515,383	10,237,119
Other borrowed funds	497,354	482,849	1,097,577	1,148,575
Total interest expense	5,608,475	4,174,670	15,612,960	11,385,694
Net interest income	5,656,470	6,360,168	17,259,228	19,319,953
Provision (credit) for loan losses	45,859	118,431	(227,371)	247,038
Net interest income after provision (credit) for loan losses	5,610,611	6,241,737	17,486,599	19,072,915
Non-interest income:				
Trust department income	336,207	271,730	1,089,285	1,015,260
Service fees	474,633	465,027	1,379,684	1,335,672
Securities gains, net	330,827	265,771	846,135	633,554
Gain on sale of loans held for sale	173,163	186,812	457,150	468,833
Merchant and ATM fees	127,108	145,006	403,328	429,209
Gain on sale or foreclosure of real estate	10,734	—	482,203	—
Other	118,701	110,473	404,894	351,314
Total non-interest income	1,571,373	1,444,819	5,062,679	4,233,842
Non-interest expense:				
Salaries and employee benefits	2,341,368	2,354,097	7,128,646	7,065,595
Data processing	541,865	469,622	1,624,142	1,515,026
Occupancy expenses	294,113	285,962	891,991	864,370
Other operating expenses	639,067	697,397	2,024,029	1,999,283

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Total non-interest expense	3,816,413	3,807,078	11,668,808	11,444,274
Income before income taxes	3,365,571	3,879,478	10,880,470	11,862,483
Income tax expense	819,999	962,102	2,657,713	2,962,871
Net income	\$ 2,545,572	\$ 2,917,376	\$ 8,222,757	\$ 8,899,612
Basic and diluted earnings per share	\$ 0.27	\$ 0.31	\$ 0.87	\$ 0.95
Declared dividends per share	\$ 0.26	\$ 0.25	\$ 0.78	\$ 0.75
Comprehensive Income	\$ 6,971,733	\$ 473,204	\$ 9,771,335	\$ 5,744,755

Index**AMES NATIONAL CORPORATION AND SUBSIDIARIES****Consolidated Statements of Cash Flows  
(unaudited)****Nine Months Ended  
September 30,****2006****2005****CASH FLOWS FROM OPERATING ACTIVITIES**

Net income	\$	8,222,757	\$	8,899,612
Adjustments to reconcile net income to net cash provided by operating activities:				
Provision (credit) for loan losses		(227,371)		247,038
Amortization and accretion		133,426		396,565
Depreciation		720,603		667,635
Provision for deferred taxes		151,694		(58,535)
Securities gains, net		(846,135)		(633,554)
Gain on foreclosure of real estate		(482,203)		-
Change in assets and liabilities:				
Decrease (increase) in loans held for sale		390,095		(521,750)
Decrease in accrued income receivable		(1,694,553)		(1,208,925)
Decrease (increase) in other assets		(222,375)		747,923
Increase in accrued expenses and other liabilities		2,016,384		914,481
<b>Net cash provided by operating activities</b>		<b>8,162,322</b>		<b>9,450,490</b>

**CASH FLOWS FROM INVESTING ACTIVITIES**

Purchase of securities available-for-sale	(51,901,443)	(49,455,168)
Proceeds from sale of securities available-for-sale	4,925,519	21,228,870
Proceeds from maturities and calls of securities available-for-sale	31,727,977	43,417,229
Net decrease in interest bearing deposits in financial institutions	2,652,453	2,601,605
Net decrease in federal funds sold	250,000	19,765,000
Net decrease (increase) in loans	15,696,626	(24,316,546)
Purchase of bank premises and equipment	(1,603,606)	(1,098,384)
<b>Net cash provided by investing activities</b>	<b>1,747,526</b>	<b>12,142,606</b>

**CASH FLOWS FROM FINANCING ACTIVITIES**

Decrease in deposits	(18,681,500)	(736,220)
Increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	14,409,801	(13,394,158)
Increase in other borrowings, net	1,411,764	-
Dividends paid	(7,254,332)	(6,244,780)
Proceeds from issuance of common stock	127,013	287,937
<b>Net cash used in financing activities</b>	<b>(9,987,254)</b>	<b>(20,087,221)</b>

<b>Net increase in cash and cash equivalents</b>	<b>(77,406)</b>	<b>1,505,875</b>
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**CASH AND DUE FROM BANKS**

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Beginning		18,092,139		18,759,086
Ending	\$	18,014,733	\$	20,264,961
Cash payments for:				
Interest	\$	15,515,486		11,359,468
Income taxes		2,869,358		3,068,666

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**AMES NATIONAL CORPORATION AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

1. Significant Accounting Policies

The consolidated financial statements for the three and nine month periods ended September 30, 2006 and 2005 are unaudited. In the opinion of the management of Ames National Corporation (the "Company"), these financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary to present fairly these consolidated financial statements. The results of operations for the interim periods are not necessarily indicative of results which may be expected for an entire year. Certain information and footnote disclosures normally included in complete financial statements prepared in accordance with generally accepted accounting principles have been omitted in accordance with the requirements for interim financial statements. The interim financial statements and notes thereto should be read in conjunction with the year-end audited financial statements contained in the Company's 10-K. The consolidated condensed financial statements include the accounts of the Company and its wholly-owned banking subsidiaries (the "Banks"). All significant intercompany balances and transactions have been eliminated in consolidation.

2. Dividends

On August 11, 2006, the Company declared a cash dividend on its common stock, payable on November 15, 2006 to stockholders of record as of November 1, 2006, equal to \$0.26 per share.

3. Earnings Per Share

Earnings per share amounts were calculated using the weighted average shares outstanding during the periods presented. The weighted average outstanding shares for the three months ended September 30, 2006 and 2005 were 9,425,013 and 9,419,271, respectively. The weighted average outstanding shares for the nine months ended September 30, 2006 and 2005 were 9,421,522 and 9,414,362, respectively.

4. Off-Balance Sheet Arrangements

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. No material changes in the Company's off-balance sheet arrangements have occurred since December 31, 2005.

5. Other Real Estate Owned

Real estate properties acquired through or in lieu of loan 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. In the unusual case where the fair market value less selling costs exceeds the loan carrying amount, a gain is recorded. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell.

During the quarter ended March 31, 2006, the Company recorded a \$471,000 gain on the foreclosure of a commercial real estate property where the fair market value determined by an independent appraisal exceeded the loan carrying amount.



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6. Expected Impact of New Accounting Pronouncement

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective in fiscal years beginning after December 15, 2006. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption, with the cumulative effect adjustment reported as an adjustment to the opening balance of retained earnings. The Company is currently evaluating the potential impact, if any, that the adoption of FIN 48 will have on its consolidated financial statements. Management believes, based on an initial evaluation, that the impact of FIN 48 will not be significant to the consolidated financial statements.

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

**Overview**

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

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 eleven individuals to assist with financial reporting, human resources, audit, compliance, marketing, technology systems and the coordination of management activities, in addition to 174 full-time equivalent individuals employed by the Banks.

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

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



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The Company earned net income of \$2,546,000, or \$0.27 per share for the three months ended September 30, 2006, compared to net income of \$2,917,000, or \$0.31 per share, for the three months ended September 30, 2005, a decrease of 13%. Net interest income for the third quarter decreased \$704,000, or 11%, from one year ago as the expense for attracting and retaining deposits rose more quickly than interest income on earning assets.

For the nine month period ending September 30, 2006, the Company earned net income of \$8,223,000, or \$0.87 per share, a 7% decrease from the net income of \$8,900,000, or \$0.95 per share, earned a year ago. As with the quarterly earnings results, the net interest income for the first nine months of 2006 decreased by \$2,061,000, a decline of 11% compared to the first nine months of 2005. Partially offsetting the lower net interest income was the 2006 year-to-date credit provision for loan losses of \$227,000 and gains on foreclosure of real estate properties of \$482,000.

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

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

**Challenges**

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

Short-term federal fund interest rates have risen 1.50% since September of last year. This rapid increase has negatively impacted the Company's net interest margin as interest expense on interest bearing liabilities increased more quickly than interest income on earning assets. Additional rapid increases in short term rates may create additional downward pressure on the Company's earnings. As a result of the short term rate increases and the competitive nature of the Company's markets, the net interest margin has fallen to 3.25% for the three months ended September 30, 2006 compared to 3.58% for the three months ended September 30, 2005. The Company's earning assets (primarily its loan and investment portfolio) have longer maturities than its interest bearing liabilities (primarily deposits and other borrowings); therefore, in a rising interest rate environment, interest expense will increase more quickly than interest income as the interest bearing liabilities reprice more quickly than earning assets. In response to this challenge, the Banks model quarterly the changes in income that would result from various changes in interest rates. Management believes Bank assets have the appropriate maturity and repricing characteristics to optimize earnings and the Banks' interest rate risk positions.

The Company's market in central Iowa has numerous banks, credit unions, and investment and insurance companies competing for similar business opportunities. This competitive environment will continue to put compression pressure on the Banks' customer interest rates, both loans and deposits, ultimately, narrowing the net interest margin and, affecting profitability. Strategic planning efforts at the Company and Banks continue to focus on capitalizing on the Banks' strengths in local markets while working to identify opportunities for improvement to gain competitive advantages.

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· A potential challenge to the Company's earnings would be poor performance in the Company's equity portfolio, thereby reducing the historical level of realized security gains. The Company, on an unconsolidated basis, invests capital that may be utilized for future expansion in a portfolio of primarily financial and utility stocks totaling \$23 million as of September 30, 2006. The Company focuses on stocks that have historically paid dividends that may lessen the negative effects of a bear market.

Index**Key Performance Indicators and Industry Results**

Certain key performance indicators for the Company and the industry are presented in the following chart. The industry figures are compiled by the Federal Deposit Insurance Corporation (FDIC) and are derived from 8,778 commercial banks and savings institutions insured by the FDIC. Management reviews these indicators on a quarterly basis for purposes of comparing the Company's performance from quarter to quarter against the industry as a whole.

## Selected Indicators for the Company and the Industry

	September 30, 2006		June 30, 2006		Years Ended December 31,			
	3	9						
	Months	Months	3 Months		2005		2004	
	Ended	Ended	Ended	Industry*	Company	Industry	Company	Industry
	Company	Company	Company					
Return on assets	1.25%	1.34%	1.35%	1.34%	1.40%	1.28%	1.56%	1.29%
Return on equity	9.36%	10.08%	10.22%	12.99%	10.57%	12.46%	11.47%	13.28%
Net interest margin	3.25%	3.29%	3.29%	3.46%	3.56%	3.49%	3.97%	3.53%
Efficiency ratio	52.80%	52.26%	53.84%	56.00%	49.09%	57.24%	46.59%	58.03%
Capital ratio	13.32%	13.32%	13.20%	8.24%	13.21%	8.25%	13.62%	8.12%

\*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 1.25% and 1.41%, respectively, for the three month periods ending September 30, 2006 and 2005. This ratio declined in 2006 from the previous year primarily as the result of lower net interest income.

#### Return on Equity

This ratio is calculated by dividing net income by average equity. It is used to measure the net income or return the Company generated for the shareholders' equity investment in the Company. The Company's annualized return on equity ratio is below that of the industry primarily as a result of the higher level of capital the Company maintains for future growth and acquisitions. The Company's return on average equity was 9.36% and 10.54%, respectively for the three month periods ending September 30, 2006 and 2005.

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Net Interest Margin

The net interest margin for the three months ended September 30, 2006 was 3.25% compared to 3.58% for the three months ended September 30, 2005. The ratio is calculated by dividing net interest income by average earning assets. Earning assets are primarily made up of loans and investments that earn interest. This ratio is used to measure how well the Company is able to maintain interest rates on earning assets above those of interest-bearing liabilities, which is the interest expense paid on deposits and other borrowings. The Company's net interest margin declined 33 basis points when compared to September 30, 2005 and is 17 basis points below the industry average as of June 30, 2006. Management expects the higher short term interest rates and the competitive nature of the Company's market environment to put downward pressure on the Company's margin for the remainder of 2006.

Efficiency Ratio

This ratio is calculated by dividing noninterest expense by net interest income and noninterest income. The ratio is a measure of the Company's ability to manage noninterest expenses. The Company's efficiency ratio compares favorably to the industry's average and was 52.80% and 48.78% for the three months ended September 30, 2006 and 2005, respectively.

Capital Ratio

The average capital ratio is calculated by dividing average total equity capital by average total assets. It measures the level of average assets that are funded by shareholders' equity. Given an equal level of risk in the financial condition of two companies, the higher the capital ratio, generally the more financially sound the company. The Company's capital ratio is significantly higher than the industry average. The capital ratio increased slightly for the latest quarter compared to the December 31, 2005 year end ratio.

Industry Results

Earnings Set New Record for Fifth Time in Last Six Quarters

Strong commercial and consumer loan demand outweighed the disadvantages of rising interest rates and a flat yield curve, enabling insured commercial banks and savings institutions to continue to post record profits in the second quarter. Quarterly net income of \$38.1 billion was \$1.2 billion (3.2%) higher than the previous record set in the first quarter, and \$3.7 billion (10.9%) higher than in the second quarter of 2005, when trading revenues at large institutions were especially weak. The improvement in net income compared to year-earlier levels came from higher non-interest income, which was \$6.7 billion (12.1%) higher, and from increased net interest income, which was up by \$4.4 billion (5.4%). Much of the improvement in non-interest income came from a rebound in trading revenues (up \$2.2 billion, or 90.1%), and servicing fees (up \$1.4 billion, or 46.7%). Lower gains on sales of securities and other assets (down \$2.0 billion, or 87.8%) and higher non-interest expenses (up \$3.3 billion, or 4.0%) limited the year-over-year improvement in quarterly earnings. Loan-loss provisions were only slightly changed from a year earlier, declining by \$17 million (0.3%). The average return on assets (ROA) was 1.34%, unchanged from both the first quarter of 2006 and the second quarter of 2005. While industry earnings continue to grow, many institutions are struggling with the flat yield curve environment. Only 56.6% of all institutions reported higher quarterly net income than a year ago, and fewer than half of all institutions (48.7%) had higher ROAs than in the second quarter of 2005.

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Profitability Trends Are Closely Tied to Trends in Net Interest Margins

The proportion of institutions reporting improved net interest margins (45.7%) is very close to the proportion reporting improved ROAs. Almost three out of every four institutions (71.9%) that reported higher quarterly net interest margins (NIM) than a year ago also reported higher ROAs. An almost identical proportion of institutions (71.2%) that experienced declining NIMs also had year-over-year declines in their quarterly ROAs. The industry's NIM in the second quarter remained unchanged from the fifteen-year low posted in the first quarter, but was 18 basis points lower than in the second quarter of 2005. As short-term interest rates have risen faster than long-term rates, increases in institutions' funding costs have outpaced increases in the yields on their investments. The resulting margin squeeze has been more pronounced at larger institutions, which rely more on short-term, interest-sensitive liabilities to fund their assets. Margins have declined at smaller institutions as well. They obtain more of their funding from retail deposits, which reprice upwards more slowly when interest rates rise, and their average funding costs have remained below the industry average. However, their assets include a larger proportion of longer-maturity loans and other investments, which reprice more slowly when interest rates rise, so the average yields on their assets have risen more slowly than other institutions.

**Income Statement Review**

The following highlights a comparative discussion of the major components of net income and their impact for the three month periods ended September 30, 2006 and 2005:

Critical Accounting Policies

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

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

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

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## 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

ASSETS (dollars in thousands)	Average balance	Three Months Ended September 30,					
		2006 Revenue	Yield	Average balance	2005 Revenue	Yield	
Interest-earning assets							
Loans							
Commercial	\$ 70,593	\$ 1,427	8.09%	\$ 66,715	\$ 1,103	6.61%	
Agricultural	33,813	727	8.60%	30,352	572	7.54%	
Real estate	305,662	4,979	6.52%	312,650	4,922	6.30%	
Installment and other	23,846	372	6.24%	30,914	439	5.68%	
Total loans (including fees)	\$ 433,914	\$ 7,505	6.92%	\$ 440,631	\$ 7,036	6.39%	
Investment securities							
Taxable	\$ 218,684	\$ 2,409	4.41%	\$ 213,712	\$ 2,180	4.08%	
Tax-exempt	121,696	1,962	6.45%	125,579	1,960	6.24%	
Total investment securities	\$ 340,380	\$ 4,371	5.14%	\$ 339,291	\$ 4,140	4.88%	
Interest bearing deposits with banks	\$ 3,921	\$ 35	3.57%	\$ 6,962	\$ 42	2.41%	
Federal funds sold	2,853	41	5.75%	215	3	5.58%	
Total interest-earning assets	\$ 781,068	\$ 11,952	6.12%	\$ 787,099	\$ 11,221	5.70%	