

AMES NATIONAL CORP  
Form 10-Q  
November 08, 2016  
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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

FORM 10-Q

[Mark One]

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

For the quarterly period ended September 30, 2016

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

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

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

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

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

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

(Class)

(Shares Outstanding at October 28, 2016)

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AMES NATIONAL CORPORATION

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| <b>ASSETS</b>   | <b>September 30,<br/>2016</b> | <b>December 31,<br/>2015</b> |
|---|-------------------------------|------------------------------|
| Cash and due from banks   | \$21,305,138                  | \$24,005,801                 |
| Interest bearing deposits in financial institutions   | 25,998,518                    | 26,993,091                   |
| Securities available-for-sale   | 517,579,320                   | 537,632,990                  |
| Loans receivable, net   | 740,321,874                   | 701,328,171                  |
| Loans held for sale   | 1,188,415                     | 539,370                      |
| Bank premises and equipment, net  | 16,342,418                    | 17,007,798                   |
| Accrued income receivable   | 8,370,918                     | 7,565,791                    |
| Other real estate owned   | 653,684                       | 1,249,915                    |
| Deferred income taxes   | -                             | 1,276,571                    |
| Core deposit intangible, net  | 1,035,525                     | 1,308,731                    |
| Goodwill  | 6,732,216                     | 6,732,216                    |
| Other assets  | 815,950                       | 1,106,698                    |
| <b>Total assets</b>   | <b>\$1,340,343,976</b>        | <b>\$1,326,747,143</b>       |
| <br><b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                               |                              |
| <b>LIABILITIES</b>  |                               |                              |
| Deposits  |                               |                              |
| Demand, noninterest bearing   | \$187,835,703                 | \$202,542,011                |
| NOW accounts  | 302,133,497                   | 298,227,493                  |
| Savings and money market  | 366,167,359                   | 354,026,475                  |
| Time, \$250,000 and over  | 35,663,074                    | 36,956,653                   |
| Other time  | 170,009,512                   | 182,440,490                  |
| <b>Total deposits</b>   | <b>1,061,809,145</b>          | <b>1,074,193,122</b>         |
| Securities sold under agreements to repurchase  | 49,858,395                    | 54,289,915                   |
| Federal Home Loan Bank (FHLB) advances  | 38,000,000                    | 18,542,203                   |
| Other borrowings  | 13,000,000                    | 13,000,000                   |
| Deferred income taxes   | 1,039,151                     | -                            |
| Dividend payable  | 1,955,292                     | 1,862,183                    |
| Accrued expenses and other liabilities  | 3,945,268                     | 3,609,663                    |
| <b>Total liabilities</b>  | <b>1,169,607,251</b>          | <b>1,165,497,086</b>         |
| <br><b>STOCKHOLDERS' EQUITY</b>   |                               |                              |
| Common stock, \$2 par value, authorized 18,000,000 shares; issued and outstanding 9,310,913 shares as of September 30, 2016 and December 31, 2015 | 18,621,826                    | 18,621,826                   |
| Additional paid-in capital  | 20,878,728                    | 20,878,728                   |

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|   |                        |                        |
|---|------------------------|------------------------|
| Retained earnings   | 124,112,244            | 118,267,767            |
| Accumulated other comprehensive income - net unrealized gain on securities available-for-sale | 7,123,927              | 3,481,736              |
| <b>Total stockholders' equity</b>   | <b>170,736,725</b>     | <b>161,250,057</b>     |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$1,340,343,976</b> | <b>\$1,326,747,143</b> |

See Notes to Consolidated Financial Statements.

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## AMES NATIONAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

*(unaudited)*

|  | Three Months Ended<br>September 30, |                   | Nine Months Ended<br>September 30, |                   |
|--|-------------------------------------|-------------------|------------------------------------|-------------------|
|  | 2016                                | 2015              | 2016                               | 2015              |
| Interest income:   |                                     |                   |                                    |                   |
| Loans, including fees                                      | \$8,236,401                         | \$7,808,414       | \$24,124,973                       | \$22,920,161      |
| Securities:  |                                     |                   |                                    |                   |
| Taxable  | 1,425,366                           | 1,506,702         | 4,392,602                          | 4,639,398         |
| Tax-exempt   | 1,329,071                           | 1,433,537         | 4,117,893                          | 4,399,623         |
| Interest bearing deposits and federal funds sold           | 86,869                              | 94,364            | 296,925                            | 288,411           |
| <b>Total interest income</b>                               | <b>11,077,707</b>                   | <b>10,843,017</b> | <b>32,932,393</b>                  | <b>32,247,593</b> |
| Interest expense:  |                                     |                   |                                    |                   |
| Deposits   | 753,642                             | 744,958           | 2,259,140                          | 2,276,004         |
| Other borrowed funds                                       | 274,297                             | 257,791           | 796,006                            | 898,565           |
| <b>Total interest expense</b>                              | <b>1,027,939</b>                    | <b>1,002,749</b>  | <b>3,055,146</b>                   | <b>3,174,569</b>  |
| <b>Net interest income</b>                                 | <b>10,049,768</b>                   | <b>9,840,268</b>  | <b>29,877,247</b>                  | <b>29,073,024</b> |
| Provision for loan losses                                  | 234,703                             | 37,797            | 440,787                            | 1,036,610         |
| <b>Net interest income after provision for loan losses</b> | <b>9,815,065</b>                    | <b>9,802,471</b>  | <b>29,436,460</b>                  | <b>28,036,414</b> |
| Noninterest income:  |                                     |                   |                                    |                   |
| Wealth management income                                   | 684,908                             | 671,699           | 2,210,229                          | 2,040,956         |
| Service fees   | 426,711                             | 445,706           | 1,228,416                          | 1,285,063         |
| Securities gains, net                                      | 64,917                              | 111,622           | 296,110                            | 608,926           |
| Gain on sale of loans held for sale                        | 339,501                             | 206,072           | 773,512                            | 705,370           |
| Merchant and card fees                                     | 350,488                             | 350,310           | 1,051,378                          | 1,016,783         |
| Other noninterest income                                   | 137,153                             | 164,568           | 469,138                            | 466,085           |
| <b>Total noninterest income</b>                            | <b>2,003,678</b>                    | <b>1,949,977</b>  | <b>6,028,783</b>                   | <b>6,123,183</b>  |
| Noninterest expense:                                       |                                     |                   |                                    |                   |
| Salaries and employee benefits                             | 3,977,495                           | 3,882,484         | 11,883,696                         | 11,418,395        |
| Data processing  | 824,429                             | 720,232           | 2,366,293                          | 2,089,363         |
| Occupancy expenses, net                                    | 449,775                             | 414,868           | 1,461,201                          | 1,408,464         |
| FDIC insurance assessments                                 | 109,289                             | 169,692           | 434,808                            | 519,962           |
| Professional fees  | 296,720                             | 346,665           | 889,721                            | 951,835           |
| Business development                                       | 239,917                             | 254,757           | 696,033                            | 719,689           |
| Other real estate owned expense (income), net              | (91,173)                            | (104,380)         | (87,564)                           | 605,830           |
| Core deposit intangible amortization                       | 86,492                              | 103,251           | 273,206                            | 326,249           |



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|                                      |                    |                    |                     |                     |
|--------------------------------------|--------------------|--------------------|---------------------|---------------------|
| Other operating expenses, net        | 219,283            | 194,639            | 750,244             | 773,430             |
| <b>Total noninterest expense</b>     | <b>6,112,227</b>   | <b>5,982,208</b>   | <b>18,667,638</b>   | <b>18,813,217</b>   |
| <b>Income before income taxes</b>    | <b>5,706,516</b>   | <b>5,770,240</b>   | <b>16,797,605</b>   | <b>15,346,380</b>   |
| Provision for income taxes           | 1,902,636          | 1,670,389          | 5,087,253           | 4,246,790           |
| <b>Net income</b>                    | <b>\$3,803,880</b> | <b>\$4,099,851</b> | <b>\$11,710,352</b> | <b>\$11,099,590</b> |
| Basic and diluted earnings per share | \$0.41             | \$0.44             | \$1.26              | \$1.19              |
| Dividends declared per share         | \$0.21             | \$0.20             | \$0.63              | \$0.60              |

See Notes to Consolidated Financial Statements.

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

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |              |
|--|---------------------------|-------------|--------------------------|--------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |              |
|  | <b>2016</b>               | <b>2015</b> | <b>2016</b>              | <b>2015</b>  |
| Net income   | \$3,803,880               | \$4,099,851 | \$11,710,352             | \$11,099,590 |
| Other comprehensive income (loss), before tax:                     |                           |             |                          |              |
| Unrealized gains (losses) on securities before tax:                |                           |             |                          |              |
| Unrealized holding gains (losses) arising during the period        | (1,838,831)               | 2,649,038   | 6,077,365                | 954,990      |
| Less: reclassification adjustment for gains realized in net income | 64,917                    | 111,622     | 296,110                  | 608,926      |
| Other comprehensive income (loss), before tax                      | (1,903,748)               | 2,537,416   | 5,781,255                | 346,064      |
| Tax effect related to other comprehensive income (loss)            | 704,387                   | (938,843)   | (2,139,064)              | (128,044)    |
| Other comprehensive income (loss), net of tax                      | (1,199,361)               | 1,598,573   | 3,642,191                | 218,020      |
| Comprehensive income   | \$2,604,519               | \$5,698,424 | \$15,352,543             | \$11,317,610 |

See Notes to Consolidated Financial Statements.

Table Of Contents**AMES NATIONAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY***(unaudited)***Nine Months Ended September 30, 2016 and 2015**

|  | Common<br>Stock | Additional<br>Paid-in-Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income, Net of<br>Taxes | Total<br>Stockholders'<br>Equity |
|--|-----------------|-------------------------------|----------------------|--|----------------------------------|
| <b>Balance, December 31, 2014</b>            | \$18,621,826    | \$ 20,878,728                 | \$110,701,847        | \$ 4,472,017   | \$154,674,418                    |
| Net income                                   | -               | -                             | 11,099,590           | -  | 11,099,590                       |
| Other comprehensive income                   | -               | -                             | -                    | 218,020  | 218,020                          |
| Cash dividends declared, \$0.60 per<br>share | -               | -                             | (5,586,548 )         | -  | (5,586,548 )                     |
| <b>Balance, September 30, 2015</b>           | \$18,621,826    | \$ 20,878,728                 | \$116,214,889        | \$ 4,690,037   | \$160,405,480                    |
| <b>Balance, December 31, 2015</b>            | \$18,621,826    | \$ 20,878,728                 | \$118,267,767        | \$ 3,481,736   | \$161,250,057                    |
| Net income                                   | -               | -                             | 11,710,352           | -  | 11,710,352                       |
| Other comprehensive income                   | -               | -                             | -                    | 3,642,191  | 3,642,191                        |
| Cash dividends declared, \$0.63 per<br>share | -               | -                             | (5,865,875 )         | -  | (5,865,875 )                     |
| <b>Balance, September 30, 2016</b>           | \$18,621,826    | \$ 20,878,728                 | \$124,112,244        | \$ 7,123,927   | \$170,736,725                    |

See Notes to Consolidated Financial Statements.

Table Of Contents**AMES NATIONAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS***(unaudited)***Nine Months Ended September 30, 2016 and 2015**

|   | <b>2016</b>         | <b>2015</b>         |
|---|---------------------|---------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                     |                     |
| Net income  | \$ 11,710,352       | \$ 11,099,590       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                     |                     |
| Provision for loan losses   | 440,787             | 1,036,610           |
| Provision for off-balance sheet commitments                                       | 12,000              | 7,000               |
| Amortization, net   | 2,327,654           | 2,590,850           |
| Amortization of core deposit intangible asset                                     | 273,206             | 326,249             |
| Depreciation  | 885,202             | 812,607             |
| Deferred income taxes   | 176,658             | 526,700             |
| Securities gains, net   | (296,110 )          | (608,926 )          |
| Loss on sale of premises and equipment, net                                       | 2,769               | 1,132               |
| Impairment of other real estate owned   | 28,039              | 614,687             |
| (Gain) on sale of other real estate owned, net                                    | (131,127 )          | (88,164 )           |
| Change in assets and liabilities:   |                     |                     |
| (Increase) in loans held for sale   | (649,045 )          | (211,472 )          |
| (Increase) in accrued income receivable   | (805,127 )          | (1,069,704 )        |
| Decrease in other assets  | 286,238             | 321,674             |
| Increase in accrued expenses and other liabilities                                | 323,605             | 546,791             |
| <b>Net cash provided by operating activities</b>                                  | <b>14,585,101</b>   | <b>15,905,624</b>   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                     |                     |
| Purchase of securities available-for-sale   | (49,668,267)        | (87,374,515)        |
| Proceeds from sale of securities available-for-sale                               | 18,738,154          | 21,305,694          |
| Proceeds from maturities and calls of securities available-for-sale               | 54,611,331          | 60,365,412          |
| Net (increase) decrease in interest bearing deposits in financial institutions    | 994,573             | (8,691,970 )        |
| Decrease in federal funds sold  | -                   | 6,000               |
| Net (increase) in loans   | (39,394,414)        | (32,535,238)        |
| Net proceeds from the sale of other real estate owned                             | 755,906             | 4,594,675           |
| Purchase of bank premises and equipment, net                                      | (218,081 )          | (1,679,676 )        |
| Other   | -                   | (28,812 )           |
| <b>Net cash (used in) investing activities</b>                                    | <b>(14,180,798)</b> | <b>(44,038,430)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                     |                     |
| Increase (decrease) in deposits   | (12,358,477)        | 9,357,287           |
| Increase (decrease) in securities sold under agreements to repurchase             | (4,431,520 )        | 800,552             |
| Payments on FHLB borrowings and other borrowings                                  | (1,542,203 )        | (10,414,260)        |
| Proceeds from short-term FHLB borrowings, net                                     | 21,000,000          | 36,200,000          |
| Dividends paid  | (5,772,766 )        | (5,400,329 )        |

|  |              |              |
|--|--------------|--------------|
| <b>Net cash provided by (used in) financing activities</b> | (3,104,966 ) | 30,543,250   |
| <b>Net increase (decrease) in cash and due from banks</b>  | (2,700,663 ) | 2,410,444    |
| <b>CASH AND DUE FROM BANKS</b>                             |              |              |
| Beginning  | 24,005,801   | 23,730,257   |
| Ending   | \$21,305,138 | \$26,140,701 |

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**AMES NATIONAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

*(unaudited)*

**Nine Months Ended September 30, 2016 and 2015**

|  | <b>2016</b> | <b>2015</b> |
|--|-------------|-------------|
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>        |             |             |
| Cash payments for:   |             |             |
| Interest   | \$3,145,519 | \$3,377,794 |
| Income taxes   | 4,223,653   | 3,246,791   |
| <b>SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES</b> |             |             |
| Transfer of loans receivable to other real estate owned        | \$56,587    | \$74,609    |

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 and nine months ended September 30, 2016 and 2015 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, 2015 (the "Annual Report"). The consolidated financial statements include the accounts of the Company and its wholly-owned banking subsidiaries (the "Banks"). All significant intercompany balances and transactions have been eliminated in consolidation.

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

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions and selecting an appropriate control premium. At September 30, 2016, Company management has performed a goodwill impairment assessment and determined goodwill was not impaired.

**Current Accounting Developments:** In January 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update ("ASU") No. 2016-01, Financial Instruments—Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*. The update enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information by updating certain aspects of recognition, measurement, presentation and disclosure of financial instruments. Among other changes, the update includes requiring changes in fair value of equity securities with readily determinable fair value to be recognized in

net income and clarifies that entities should evaluate the need for a valuation allowance on a deferred tax asset related to available for sale securities in combination with the entities' other deferred tax assets. For public companies, this update will be effective for interim and annual periods beginning after December 15, 2017, and is to be applied on a modified retrospective basis. The Company is currently assessing the impact that this guidance will have on its consolidated financial statements, but does not expect the guidance to have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The ASU requires a lessee to recognize on the balance sheet assets and liabilities for leases with lease terms of more than 12 months. Consistent with current Generally Accepted Accounting Principles ("GAAP"), the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. Unlike current GAAP, which requires that only capital leases be recognized on the balance sheet, the ASC requires that both types of leases be recognized on the balance sheet. For public companies, this update will be effective for interim and annual periods beginning after December 15, 2018. Early application is permitted. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.



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In February 2016, the FASB issued ASU Update No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. Among other items the ASC requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. For public companies, this update will be effective for interim and annual periods beginning after December 15, 2017. The effect of the adoption of this guidance has not yet been determined by the Company.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU requires an organization to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. Additionally, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. For public companies, this update will be effective for interim and annual periods beginning after December 15, 2019. The effect of the adoption of this guidance has not yet been determined by the Company.

### 2.Dividends

On August 10, 2016, the Company declared a cash dividend on its common stock, payable on November 15, 2016 to stockholders of record as of November 1, 2016, equal to \$0.21 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 and nine months ended September 30, 2016 and 2015 were 9,310,913. The Company had no potentially dilutive securities outstanding during the periods presented.

### 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, 2015.

## 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.

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Level 2: Inputs to the valuation methodology include: quoted prices for similar assets or liabilities in active markets; quoted prices 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.

The following table presents the balances of assets measured at fair value on a recurring basis by level as of September 30, 2016 and December 31, 2015. *(in thousands)*

| Description                                | Total     | Level<br>1 | Level 2   | Level<br>3 |
|--|-----------|------------|-----------|------------|
| <b>2016</b>                                |           |            |           |            |
| U.S. government treasuries                 | \$1,505   | \$1,505    | \$-       | \$ -       |
| U.S. government agencies                   | 108,222   | -          | 108,222   | -          |
| U.S. government mortgage-backed securities | 82,685    | -          | 82,685    | -          |
| State and political subdivisions           | 266,535   | -          | 266,535   | -          |
| Corporate bonds                            | 54,678    | -          | 54,678    | -          |
| Equity securities, other                   | 3,954     | -          | 3,954     | -          |
|  | \$517,579 | \$1,505    | \$516,074 | \$ -       |
| <b>2015</b>                                |           |            |           |            |
| U.S. government treasuries                 | \$1,467   | \$1,467    | \$-       | \$ -       |
| U.S. government agencies                   | 106,445   | -          | 106,445   | -          |
| U.S. government mortgage-backed securities | 98,079    | -          | 98,079    | -          |
| State and political subdivisions           | 277,597   | -          | 277,597   | -          |
| Corporate bonds                            | 50,889    | -          | 50,889    | -          |
| Equity securities, other                   | 3,156     | -          | 3,156     | -          |
|  | \$537,633 | \$1,467    | \$536,166 | \$ -       |

Level 1 securities include U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets. U.S government mortgage-backed securities, state and political subdivisions, most corporate bonds and

other equity securities are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the security's terms and conditions, among other things.

The Company's policy is to recognize transfers between levels at the end of each reporting period, if applicable. There were no transfers between levels of the fair value hierarchy during the nine months ended September 30, 2016.

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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 within the valuation hierarchy as of September 30, 2016 and December 31, 2015. *(in thousands)*

| Description             | Total   | Level<br>1 | Level<br>2 | Level<br>3 |
|-------------------------|---------|------------|------------|------------|
| <b>2016</b>             |         |            |            |            |
| Loans receivable        | \$1,185 | \$ -       | \$ -       | \$1,185    |
| Other real estate owned | 654     | -          | -          | 654        |
| Total                   | \$1,839 | \$ -       | \$ -       | \$1,839    |
| <b>2015</b>             |         |            |            |            |
| Loans receivable        | \$603   | \$ -       | \$ -       | \$603      |
| Other real estate owned | 1,250   | -          | -          | 1,250      |
| Total                   | \$1,853 | \$ -       | \$ -       | \$1,853    |

**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 allowance 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, with any impairment amount charged to the allowance for loan losses. Subsequent to the transfer, other real estate owned is carried at the lower of cost or fair value, less estimated selling costs, with any impairment amount recorded as a noninterest expense. 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 \$426,000 as of September 30, 2016 and \$681,000 as of December 31, 2015. The Company considers these fair value measurements as level 3.



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The significant inputs used in the fair value measurements for Level 3 assets measured at fair value on a nonrecurring basis as of September 30, 2016 and December 31, 2015 are as follows: *(in thousands)*

|                            | <b>2016</b>             |                             |                        |                    |      |
|----------------------------|-------------------------|-----------------------------|------------------------|--------------------|------|
|                            | Estimated<br>Fair Value | Valuation<br>Techniques     | Unobservable<br>Inputs | Range<br>(Average) |      |
| Impaired Loans             | \$ 1,185                | Evaluation of<br>collateral | Estimation of value    | NM*                |      |
| Other real estate<br>owned | \$ 654                  | Appraisal                   | Appraisal adjustment   | 6% - 8%            | (7%) |
|                            |                         |                             |                        |                    |      |
|                            | <b>2015</b>             |                             |                        |                    |      |
|                            | Estimated<br>Fair Value | Valuation<br>Techniques     | Unobservable<br>Inputs | Range<br>(Average) |      |
| Impaired Loans             | \$ 603                  | Evaluation of<br>collateral | Estimation of value    | NM*                |      |
| Other real estate<br>owned | \$ 1,250                | 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.

GAAP requires disclosure of the fair value of financial assets and financial liabilities, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis. The methodologies for estimating the fair value of financial assets and financial liabilities that are measured at fair value on a recurring or nonrecurring basis are discussed above. The methodologies for other financial assets and financial liabilities are discussed below.

**Fair value of financial instruments:**

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

The following disclosures represent financial instruments in which the ending balances at September 30, 2016 and December 31, 2015 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.



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

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.

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

Deposits: 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: The carrying amounts of securities sold under agreements to repurchase approximate fair value because of the generally short-term nature of the instruments.

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

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

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

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

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The estimated fair values of the Company's financial instruments as described above as of September 30, 2016 and December 31, 2015 are as follows: *(in thousands)*

|  | Fair Value<br>Hierarchy<br>Level | 2016<br>Carrying<br>Amount | Estimated<br>Fair<br>Value | 2015<br>Carrying<br>Amount | Estimated<br>Fair<br>Value |
|--|----------------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| Financial assets:                              |                                  |                            |                            |                            |                            |
| Cash and due from banks                        | Level 1                          | \$21,305                   | \$21,305                   | \$24,006                   | \$24,006                   |
| Interest bearing deposits                      | Level 1                          | 25,999                     | 25,999                     | 26,993                     | 26,993                     |
| Securities available-for-sale                  | See previous table               | 517,579                    | 517,579                    | 537,633                    | 537,633                    |
| Loans receivable, net                          | Level 2                          | 740,322                    | 741,279                    | 701,328                    | 702,438                    |
| Loans held for sale                            | Level 2                          | 1,188                      | 1,188                      | 539                        | 539                        |
| Accrued income receivable                      | Level 1                          | 8,371                      | 8,371                      | 7,566                      | 7,566                      |
| Financial liabilities:                         |                                  |                            |                            |                            |                            |
| Deposits                                       | Level 2                          | \$1,061,809                | \$1,063,219                | \$1,074,193                | \$1,075,289                |
| Securities sold under agreements to repurchase | Level 1                          | 49,858                     | 49,858                     | 54,290                     | 54,290                     |
| FHLB advances                                  | Level 2                          | 38,000                     | 38,304                     | 18,542                     | 19,017                     |
| Other borrowings                               | Level 2                          | 13,000                     | 13,510                     | 13,000                     | 13,807                     |
| Accrued interest payable                       | Level 1                          | 348                        | 348                        | 413                        | 413                        |

The methodologies used to determine fair value as of September 30, 2016 did not change from the methodologies described in the December 31, 2015 Annual Financial Statements.

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## 6. Debt and Equity Securities

The amortized cost of securities available-for-sale and their fair values as of September 30, 2016 and December 31, 2015 are summarized below: *(in thousands)*

|  | Amortized<br>Cost | Gross               | Gross                | Estimated<br>Fair<br>Value |
|--|-------------------|---------------------|----------------------|----------------------------|
|  |                   | Unrealized<br>Gains | Unrealized<br>Losses |                            |
| <b>2016:</b>                               |                   |                     |                      |                            |
| U.S. government treasuries                 | \$ 1,454          | \$ 51               | \$ -                 | \$ 1,505                   |
| U.S. government agencies                   | 105,400           | 2,865               | (43 )                | 108,222                    |
| U.S. government mortgage-backed securities | 79,916            | 2,769               | -                    | 82,685                     |
| State and political subdivisions           | 261,981           | 4,823               | (269 )               | 266,535                    |
| Corporate bonds                            | 53,566            | 1,163               | (51 )                | 54,678                     |
| Equity securities, other                   | 3,954             | -                   | -                    | 3,954                      |
|  | \$ 506,271        | \$ 11,671           | \$ (363 )            | \$ 517,579                 |

|  | Amortized<br>Cost | Gross               | Gross                | Estimated<br>Fair<br>Value |
|--|-------------------|---------------------|----------------------|----------------------------|
|  |                   | Unrealized<br>Gains | Unrealized<br>Losses |                            |
| <b>2015:</b>                               |                   |                     |                      |                            |
| U.S. government treasuries                 | \$ 1,444          | \$ 23               | \$ -                 | \$ 1,467                   |
| U.S. government agencies                   | 105,948           | 797                 | (300 )               | 106,445                    |
| U.S. government mortgage-backed securities | 96,373            | 1,828               | (123 )               | 98,078                     |
| State and political subdivisions           | 273,771           | 4,359               | (533 )               | 277,597                    |
| Corporate bonds                            | 51,414            | 227                 | (751 )               | 50,890                     |
| Equity securities, other                   | 3,156             | -                   | -                    | 3,156                      |
|  | \$ 532,106        | \$ 7,234            | \$ (1,707 )          | \$ 537,633                 |

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

|  | Three Months<br>Ended<br>September 30, |             | Nine Months<br>Ended<br>September 30, |             |
|--|--|-------------|---------------------------------------|-------------|
|  | <b>2016</b>                            | <b>2015</b> | <b>2016</b>                           | <b>2015</b> |
| Proceeds from sales of securities available-for-sale   | \$5,852                                | \$5,926     | \$18,738                              | \$21,306    |
| Gross realized gains on securities available-for-sale  | 66                                     | 126         | 303                                   | 623         |
| Gross realized losses on securities available-for-sale | (1 )                                   | (14 )       | (7 )                                  | (14 )       |

|   |    |    |     |     |
|---|----|----|-----|-----|
| Tax provision applicable to net realized gains on securities available-for-sale | 29 | 42 | 110 | 227 |
|---|----|----|-----|-----|

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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 of September 30, 2016 and December 31, 2015 are as follows: (*in thousands*)

|  | Less than 12 Months        |                      | 12 Months or More          |                      | Total                      |                      |             |
|--|----------------------------|----------------------|----------------------------|----------------------|----------------------------|----------------------|-------------|
|  | Estimated<br>Fair<br>Value | Unrealized<br>Losses | Estimated<br>Fair<br>Value | Unrealized<br>Losses | Estimated<br>Fair<br>Value | Unrealized<br>Losses |             |
| <b>2016:</b>                               |                            |                      |                            |                      |                            |                      |             |
| Securities available-for-sale:             |                            |                      |                            |                      |                            |                      |             |
| U.S. government agencies                   | \$4,014                    | \$ (43 )             | \$-                        | \$ -                 | \$4,014                    | \$ (43 )             |             |
| State and political subdivisions           | 22,711                     | (262 )               | 1,725                      | (7 )                 | 24,436                     | (269 )               |             |
| Corporate bonds                            | 2,106                      | (14 )                | 3,275                      | (37 )                | 5,381                      | (51 )                |             |
|  | \$28,831                   | \$ (319 )            | \$5,000                    | \$ (44 )             | \$33,831                   | \$ (363 )            |             |
| <b>2015:</b>                               |                            |                      |                            |                      |                            |                      |             |
| Securities available-for-sale:             |                            |                      |                            |                      |                            |                      |             |
| U.S. government agencies                   |                            | \$30,245             | \$ (253 )                  | \$3,121              | \$ (47 )                   | \$33,366             | \$ (300 )   |
| U.S. government mortgage-backed securities |                            | 22,842               | (123 )                     | -                    | -                          | 22,842               | (123 )      |
| State and political subdivisions           |                            | 38,202               | (414 )                     | 11,096               | (119 )                     | 49,298               | (533 )      |
| Corporate bonds                            |                            | 22,091               | (249 )                     | 14,614               | (502 )                     | 36,705               | (751 )      |
|  |                            | \$113,380            | \$ (1,039 )                | \$28,831             | \$ (668 )                  | \$142,211            | \$ (1,707 ) |

Gross unrealized losses on debt securities totaled \$363,000 as of September 30, 2016. 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, state or political subdivision, or corporations. Management then determines whether downgrades by bond rating agencies have occurred, and reviews industry analysts' reports. 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. 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. Loans Receivable and Credit Disclosures

Activity in the allowance for loan losses, on a disaggregated basis, for the three and nine months ended September 30, 2016 and 2015 is as follows: *(in thousands)*

**Three Months Ended September 30, 2016**

|                                    | 1-4<br>Family                  |                               |                              |                                |            |              |        | Consumer<br>and<br>Other | Total |
|------------------------------------|--------------------------------|-------------------------------|------------------------------|--------------------------------|------------|--------------|--------|--------------------------|-------|
|                                    | Construction<br>Real<br>Estate | Residential<br>Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural |        |                          |       |
| Balance, June 30, 2016             | \$758                          | \$ 1,742                      | \$ 3,890                     | \$ 834                         | \$ 1,439   | \$ 1,219     | \$ 253 | \$10,135                 |       |
| Provision (credit) for loan losses | 121                            | 32                            | (89 )                        | -                              | 169        | 12           | (10 )  | 235                      |       |
| Recoveries of loans charged-off    | 15                             | 1                             | -                            | -                              | 75         | -            | 2      | 93                       |       |
| Loans charged-off                  | -                              | -                             | -                            | -                              | (1 )       | -            | (11 )  | (12 )                    |       |
| Balance, September 30, 2016        | \$894                          | \$ 1,775                      | \$ 3,801                     | \$ 834                         | \$ 1,682   | \$ 1,231     | \$ 234 | \$10,451                 |       |

**Nine Months Ended September 30, 2016**

|                                    | 1-4<br>Family                  |                               |                              |                                |            |              |        | Consumer<br>and<br>Other | Total |
|------------------------------------|--------------------------------|-------------------------------|------------------------------|--------------------------------|------------|--------------|--------|--------------------------|-------|
|                                    | Construction<br>Real<br>Estate | Residential<br>Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural |        |                          |       |
| Balance, December 31, 2015         | \$999                          | \$ 1,806                      | \$ 3,557                     | \$ 760                         | \$ 1,371   | \$ 1,256     | \$ 239 | \$9,988                  |       |
| Provision (credit) for loan losses | (135)                          | (34 )                         | 244                          | 74                             | 308        | (25 )        | 9      | 441                      |       |
| Recoveries of loans charged-off    | 30                             | 3                             | -                            | -                              | 81         | -            | 7      | 121                      |       |
| Loans charged-off                  | -                              | -                             | -                            | -                              | (78 )      | -            | (21 )  | (99 )                    |       |
| Balance, September 30, 2016        | \$894                          | \$ 1,775                      | \$ 3,801                     | \$ 834                         | \$ 1,682   | \$ 1,231     | \$ 234 | \$10,451                 |       |

**Three Months Ended September 30, 2015**

|  | 1-4<br>Family                  |                               |                              |                                |            |              |  | Consumer<br>and<br>Other | Total |
|--|--------------------------------|-------------------------------|------------------------------|--------------------------------|------------|--------------|--|--------------------------|-------|
|  | Construction<br>Real<br>Estate | Residential<br>Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural |  |                          |       |



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|                                 |       |          |          |        |          |          |        |         |
|---------------------------------|-------|----------|----------|--------|----------|----------|--------|---------|
| Balance, June 30, 2015          | \$823 | \$ 1,826 | \$ 3,590 | \$ 812 | \$ 1,263 | \$ 1,338 | \$ 220 | \$9,872 |
| Provision for loan losses       | 130   | (10 )    | (129 )   | (20 )  | 97       | (44 )    | 14     | 38      |
| Recoveries of loans charged-off | 15    | 2        | -        | -      | -        | -        | 16     | 33      |
| Loans charged-off               | -     | (1 )     | -        | -      | -        | -        | (15 )  | (16 )   |
| Balance, September 30, 2015     | \$968 | \$ 1,817 | \$ 3,461 | \$ 792 | \$ 1,360 | \$ 1,294 | \$ 235 | \$9,927 |

**Nine Months Ended September 30, 2015**

|                                 | 1-4<br>Family<br>Construction |             |             |             |            |              |                    |         |
|---------------------------------|-------------------------------|-------------|-------------|-------------|------------|--------------|--------------------|---------|
|                                 | Real Estate                   | Real Estate | Real Estate | Real Estate | Commercial | Agricultural | Consumer and Other | Total   |
| Balance, December 31, 2014      | \$495                         | \$ 1,648    | \$ 3,214    | \$ 737      | \$ 1,247   | \$ 1,312     | \$ 186             | \$8,839 |
| Provision for loan losses       | 438                           | 154         | 247         | 55          | 113        | (18 )        | 48                 | 1,037   |
| Recoveries of loans charged-off | 35                            | 22          | -           | -           | -          | -            | 24                 | 81      |
| Loans charged-off               | -                             | (7 )        | -           | -           | -          | -            | (23 )              | (30 )   |
| Balance, September 30, 2015     | \$968                         | \$ 1,817    | \$ 3,461    | \$ 792      | \$ 1,360   | \$ 1,294     | \$ 235             | \$9,927 |

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Allowance for loan losses disaggregated on the basis of impairment analysis method as of September 30, 2016 and December 31, 2015 is as follows: *(in thousands)*

| 2016                                  | 1-4<br>Family                  |                               |                              |                                |            |              |        | Consumer<br>and<br>Other | Total |
|---------------------------------------|--------------------------------|-------------------------------|------------------------------|--------------------------------|------------|--------------|--------|--------------------------|-------|
|                                       | Construction<br>Real<br>Estate | Residential<br>Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural |        |                          |       |
| Individually evaluated for impairment | \$ -                           | \$ 140                        | \$ -                         | \$ -                           | \$ 576     | \$ -         | \$ -   | \$ 716                   |       |
| Collectively evaluated for impairment | 894                            | 1,635                         | 3,801                        | 834                            | 1,106      | 1,231        | 234    | 9,735                    |       |
| Balance September 30, 2016            | \$ 894                         | \$ 1,775                      | \$ 3,801                     | \$ 834                         | \$ 1,682   | \$ 1,231     | \$ 234 | \$ 10,451                |       |

| 2015                                  | 1-4<br>Family                  |                               |                              |                                |            |              |        | Consumer<br>and<br>Other | Total |
|---------------------------------------|--------------------------------|-------------------------------|------------------------------|--------------------------------|------------|--------------|--------|--------------------------|-------|
|                                       | Construction<br>Real<br>Estate | Residential<br>Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural |        |                          |       |
| Individually evaluated for impairment | \$ -                           | \$ 273                        | \$ 2                         | \$ -                           | \$ 164     | \$ -         | \$ -   | \$ 439                   |       |
| Collectively evaluated for impairment | 999                            | 1,533                         | 3,555                        | 760                            | 1,207      | 1,256        | 239    | 9,549                    |       |
| Balance December 31, 2015             | \$ 999                         | \$ 1,806                      | \$ 3,557                     | \$ 760                         | \$ 1,371   | \$ 1,256     | \$ 239 | \$ 9,988                 |       |

Loans receivable disaggregated on the basis of impairment analysis method as of September 30, 2016 and December 31, 2015 is as follows: *(in thousands)*:

| 2016                                  | 1-4<br>Family                  |                               |                              |                                |            |              |           | Consumer<br>and<br>Other | Total |
|---------------------------------------|--------------------------------|-------------------------------|------------------------------|--------------------------------|------------|--------------|-----------|--------------------------|-------|
|                                       | Construction<br>Real<br>Estate | Residential<br>Real<br>Estate | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial | Agricultural |           |                          |       |
| Individually evaluated for impairment | \$ -                           | \$ 1,047                      | \$ 431                       | \$ -                           | \$ 1,406   | \$ 11        | \$ 85     | \$ 2,980                 |       |
| Collectively evaluated for impairment | 58,639                         | 148,950                       | 302,608                      | 69,824                         | 71,039     | 75,850       | 20,988    | 747,898                  |       |
|                                       | \$ 58,639                      | \$ 149,997                    | \$ 303,039                   | \$ 69,824                      | \$ 72,445  | \$ 75,861    | \$ 21,073 | \$ 750,878               |       |

Balance September  
30, 2016

| 2015  | 1-4<br>Family                  |                               | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Commercial<br>Commercial | Agricultural | Consumer<br>and<br>Other | Total      |
|---|--------------------------------|-------------------------------|------------------------------|--------------------------------|--------------------------|--------------|--------------------------|------------|
|   | Construction<br>Real<br>Estate | Residential<br>Real<br>Estate |                              |                                |                          |              |                          |            |
| Individually<br>evaluated for<br>impairment | \$ -                           | \$ 1,050                      | \$ 558                       | \$ -                           | \$ 197                   | \$ 11        | \$ 2                     | \$ 1,818   |
| Collectively<br>evaluated for<br>impairment | 66,268                         | 126,026                       | 251,331                      | 62,530                         | 102,318                  | 79,522       | 21,597                   | 709,592    |
| Balance December<br>31, 2015                | \$ 66,268                      | \$ 127,076                    | \$ 251,889                   | \$ 62,530                      | \$ 102,515               | \$ 79,533    | \$ 21,599                | \$ 711,410 |

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.

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The following is a recap of impaired loans, on a disaggregated basis, as of September 30, 2016 and December 31, 2015: *(in thousands)*

|   | 2016                   |                                |                      | 2015                   |                                |                      |
|---|------------------------|--------------------------------|----------------------|------------------------|--------------------------------|----------------------|
|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| With no specific reserve recorded:      |                        |                                |                      |                        |                                |                      |
| Real estate - construction              | \$-                    | \$ -                           | \$ -                 | \$-                    | \$ 31                          | \$ -                 |
| Real estate - 1 to 4 family residential | 428                    | 447                            | -                    | 296                    | 304                            | -                    |
| Real estate - commercial                | 431                    | 1,044                          | -                    | 456                    | 1,030                          | -                    |
| Real estate - agricultural              | -                      | -                              | -                    | -                      | -                              | -                    |
| Commercial                              | 124                    | 133                            | -                    | 11                     | 17                             | -                    |
| Agricultural                            | 11                     | 13                             | -                    | 11                     | 13                             | -                    |
| Consumer and other                      | 85                     | 88                             | -                    | 2                      | 2                              | -                    |
| Total loans with no specific reserve:   | 1,079                  | 1,725                          | -                    | 776                    | 1,397                          | -                    |
| With an allowance recorded:             |                        |                                |                      |                        |                                |                      |
| Real estate - construction              | -                      | -                              | -                    | -                      | -                              | -                    |
| Real estate - 1 to 4 family residential | 619                    | 766                            | 140                  | 754                    | 891                            | 273                  |
| Real estate - commercial                | -                      | -                              | -                    | 102                    | 111                            | 2                    |
| Real estate - agricultural              | -                      | -                              | -                    | -                      | -                              | -                    |
| Commercial                              | 1,282                  | 1,283                          | 576                  | 186                    | 262                            | 164                  |
| Agricultural                            | -                      | -                              | -                    | -                      | -                              | -                    |
| Consumer and other                      | -                      | -                              | -                    | -                      | -                              | -                    |
| Total loans with specific reserve:      | 1,901                  | 2,049                          | 716                  | 1,042                  | 1,264                          | 439                  |
| Total                                   |                        |                                |                      |                        |                                |                      |
| Real estate - construction              | -                      | -                              | -                    | -                      | 31                             | -                    |
| Real estate - 1 to 4 family residential | 1,047                  | 1,213                          | 140                  | 1,050                  | 1,195                          | 273                  |
| Real estate - commercial                | 431                    | 1,044                          | -                    | 558                    | 1,141                          | 2                    |
| Real estate - agricultural              | -                      | -                              | -                    | -                      | -                              | -                    |
| Commercial                              | 1,406                  | 1,416                          | 576                  | 197                    | 279                            | 164                  |
| Agricultural                            | 11                     | 13                             | -                    | 11                     | 13                             | -                    |
| Consumer and other                      | 85                     | 88                             | -                    | 2                      | 2                              | -                    |
|   | \$2,980                | \$ 3,774                       | \$ 716               | \$1,818                | \$ 2,661                       | \$ 439               |

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The following is a recap of the average recorded investment and interest income recognized on impaired loans for the three and nine months ended September 30, 2016 and 2015: *(in thousands)*

|   | <b>Three Months Ended September 30,</b> |            |                                     |            |
|---|---|------------|-------------------------------------|------------|
|   | <b>2016</b>                             |            | <b>2015</b>                         |            |
|   | Average Interest<br>Recorded Income     |            | Average Interest<br>Recorded Income |            |
|   | Investment                              | Recognized | Investment                          | Recognized |
| With no specific reserve recorded:      |   |            |                                     |            |
| Real estate - construction              | \$-                                     | \$ -       | \$51                                | \$ 62      |
| Real estate - 1 to 4 family residential | 481                                     | -          | 250                                 | -          |
| Real estate - commercial                | 450                                     | -          | 525                                 | -          |
| Real estate - agricultural              | -                                       | -          | -                                   | -          |
| Commercial                              | 67                                      | -          | 94                                  | -          |
| Agricultural                            | 11                                      | -          | 11                                  | -          |
| Consumer and other                      | 88                                      | 6          | 4                                   | -          |
| Total loans with no specific reserve:   | 1,097                                   | 6          | 935                                 | 62         |
| With an allowance recorded:             |   |            |                                     |            |
| Real estate - construction              | -                                       | -          | -                                   | -          |
| Real estate - 1 to 4 family residential | 626                                     | -          | 761                                 | -          |
| Real estate - commercial                | -                                       | -          | 129                                 | -          |
| Real estate - agricultural              | -                                       | -          | -                                   | -          |
| Commercial                              | 1,003                                   | 2          | 131                                 | -          |
| Agricultural                            | -                                       | -          | -                                   | -          |
| Consumer and other                      | 1                                       | -          | -                                   | -          |
| Total loans with specific reserve:      | 1,630                                   | 2          | 1,021                               | -          |
| Total                                   |   |            |                                     |            |
| Real estate - construction              | -                                       | -          | 51                                  | 62         |
| Real estate - 1 to 4 family residential | 1,107                                   | -          | 1,011                               | -          |
| Real estate - commercial                | 450                                     | -          | 654                                 | -          |
| Real estate - agricultural              | -                                       | -          | -                                   | -          |
| Commercial                              | 1,070                                   | 2          | 225                                 | -          |
| Agricultural                            | 11                                      | -          | 11                                  | -          |
| Consumer and other                      | 89                                      | 6          | 4                                   | -          |
|   | \$2,727                                 | \$ 8       | \$1,956                             | \$ 62      |

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|   | <b>Nine Months Ended September 30,</b> |            |                           |            |
|---|--|------------|---------------------------|------------|
|   | <b>2016</b>                            |            | <b>2015</b>               |            |
|   | Average Interest Recorded              |            | Average Interest Recorded |            |
|   | Income Recognized                      |            | Income Recognized         |            |
|   | Investment                             | Recognized | Investment                | Recognized |
| With no specific reserve recorded:      |  |            |                           |            |
| Real estate - construction              | \$-                                    | \$ 31      | \$121                     | \$ 129     |
| Real estate - 1 to 4 family residential | 438                                    | 1          | 161                       | -          |
| Real estate - commercial                | 465                                    | 22         | 579                       | 23         |
| Real estate - agricultural              | -                                      | -          | -                         | -          |
| Commercial                              | 39                                     | -          | 276                       | 3          |
| Agricultural                            | 11                                     | -          | 13                        | -          |
| Consumer and other                      | 66                                     | 6          | 5                         | 2          |
| Total loans with no specific reserve:   | 1,019                                  | 60         | 1,155                     | 157        |
| With an allowance recorded:             |  |            |                           |            |
| Real estate - construction              | -                                      | -          | -                         | -          |
| Real estate - 1 to 4 family residential | 663                                    | 5          | 772                       | -          |
| Real estate - commercial                | 26                                     | -          | 143                       | -          |
| Real estate - agricultural              | -                                      | -          | -                         | -          |
| Commercial                              | 732                                    | 2          | 106                       | -          |
| Agricultural                            | -                                      | -          | -                         | -          |
| Consumer and other                      | 1                                      | -          | -                         | -          |
| Total loans with specific reserve:      | 1,422                                  | 7          | 1,021                     | -          |
| Total                                   |  |            |                           |            |
| Real estate - construction              | -                                      | 31         | 121                       | 129        |
| Real estate - 1 to 4 family residential | 1,101                                  | 6          | 933                       | -          |
| Real estate - commercial                | 491                                    | 22         | 722                       | 23         |
| Real estate - agricultural              | -                                      | -          | -                         | -          |
| Commercial                              | 771                                    | 2          | 382                       | 3          |
| Agricultural                            | 11                                     | -          | 13                        | -          |
| Consumer and other                      | 67                                     | 6          | 5                         | 2          |
|   | \$2,441                                | \$ 67      | \$2,176                   | \$ 157     |

The interest foregone on nonaccrual loans for the three months ended September 30, 2016 and 2015 was approximately \$46,000 and \$39,000, respectively. The interest foregone on nonaccrual loans for the nine months ended September 30, 2016 and 2015 was approximately \$124,000 and \$127,000, respectively

The Company had loans meeting the definition of a troubled debt restructuring (TDR) of \$1,388,000 as of September 30, 2016, of which all were included in impaired loans and nonaccrual loans. The Company had TDRs of \$780,000 as of December 31, 2015, all of which were included in impaired and nonaccrual loans.



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The following tables sets forth information on the Company's TDRs, on a disaggregated basis, occurring in the three and nine months ended September 30, 2016 and 2015: *(dollars in thousands)*

|   | <b>Three Months Ended September 30,</b> |                                  |                                    |                                  |
|---|---|----------------------------------|------------------------------------|----------------------------------|
|   | <b>2016</b>                             |                                  | <b>2015</b>                        |                                  |
|   | Pre-Modification<br>Outstanding         | Post-Modification<br>Outstanding | Pre-Modification<br>Outstanding    | Post-Modification<br>Outstanding |
|   | Number<br>of Recorded<br>Contracts      | Investment                       | Number<br>of Recorded<br>Contracts | Investment                       |
| Real estate - construction              | - \$ -                                  | \$ -                             | - \$ -                             | \$ -                             |
| Real estate - 1 to 4 family residential | -                                       | -                                | -                                  | -                                |
| Real estate - commercial                | -                                       | -                                | -                                  | -                                |
| Real estate - agricultural              | -                                       | -                                | -                                  | -                                |
| Commercial                              | -                                       | -                                | -                                  | -                                |
| Agricultural                            | -                                       | -                                | -                                  | -                                |
| Consumer and other                      | -                                       | -                                | -                                  | -                                |
|   | - \$ -                                  | \$ -                             | - \$ -                             | \$ -                             |

|   | <b>Nine Months Ended September 30,</b> |                                  |                                    |                                  |
|---|--|----------------------------------|------------------------------------|----------------------------------|
|   | <b>2016</b>                            |                                  | <b>2015</b>                        |                                  |
|   | Pre-Modification<br>Outstanding        | Post-Modification<br>Outstanding | Pre-Modification<br>Outstanding    | Post-Modification<br>Outstanding |
|   | Number<br>of Recorded<br>Contracts     | Investment                       | Number<br>of Recorded<br>Contracts | Investment                       |
| Real estate - construction              | - \$ -                                 | \$ -                             | - \$ -                             | \$ -                             |
| Real estate - 1 to 4 family residential | -                                      | -                                | -                                  | -                                |
| Real estate - commercial                | -                                      | -                                | -                                  | -                                |
| Real estate - agricultural              | -                                      | -                                | -                                  | -                                |
| Commercial                              | 3                                      | 702                              | -                                  | 705                              |
| Agricultural                            | -                                      | -                                | -                                  | -                                |
| Consumer and other                      | 3                                      | 70                               | -                                  | 70                               |
|   | 6 \$ 772                               | \$ 775                           | - \$ -                             | \$ -                             |

During the three months ended September 30, 2016, the Company did not grant concessions to any borrowers that were experiencing financial difficulties. During the nine months ended September 30, 2016, the Company granted



concessions to two borrowers experiencing financial difficulties with six loans. The three consumer loans were extended beyond normal terms at an interest rate below a market interest rate. The three commercial operating loans were extended beyond normal terms.

The Company did not grant any concessions on any significant loans experiencing financial difficulties during the three and nine months ended September 30, 2015.

The Company considers TDR loans to have payment default when it is past due 60 days or more.

Three TDR loans modified during the twelve months ended September 30, 2016 had payment defaults. No TDR modified during the twelve months ended September 30, 2015 had payment defaults.

There were no charge-offs related to TDRs for the nine months ended September 30, 2016 and 2015.

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An aging analysis of the recorded investments in loans, on a disaggregated basis, as of September 30, 2016 and December 31, 2015, is as follows: *(in thousands)*

| 2016                                    | 90 Days<br>or<br>Greater |             |                      | Total<br>Current | Total     | 90 Days<br>or<br>Greater<br>Accruing |
|---|--------------------------|-------------|----------------------|------------------|-----------|--------------------------------------|
|   | 30-89<br>Past<br>Due     | Past<br>Due | Total<br>Past<br>Due |                  |           |                                      |
| Real estate - construction              | \$64                     | \$ -        | \$64                 | \$58,575         | \$58,639  | \$ -                                 |
| Real estate - 1 to 4 family residential | 940                      | 167         | 1,107                | 148,890          | 149,997   | -                                    |
| Real estate - commercial                | 1,172                    | -           | 1,172                | 301,867          | 303,039   | -                                    |
| Real estate - agricultural              | -                        | -           | -                    | 69,824           | 69,824    | -                                    |
| Commercial                              | 1,244                    | 38          | 1,282                | 71,163           | 72,445    | -                                    |
| Agricultural                            | 69                       | -           | 69                   | 75,792           | 75,861    | -                                    |
| Consumer and other                      | 30                       | 16          | 46                   | 21,027           | 21,073    | -                                    |
|   | \$3,519                  | \$ 221      | \$3,740              | \$747,138        | \$750,878 | \$ -                                 |

| 2015                                    | 90 Days<br>or<br>Greater |             |                      | Total<br>Current | Total     | 90 Days<br>or<br>Greater<br>Accruing |
|---|--------------------------|-------------|----------------------|------------------|-----------|--------------------------------------|
|   | 30-89<br>Past<br>Due     | Past<br>Due | Total<br>Past<br>Due |                  |           |                                      |
| Real estate - construction              | \$-                      | \$ -        | \$-                  | \$66,268         | \$66,268  | \$ -                                 |
| Real estate - 1 to 4 family residential | 1,311                    | 307         | 1,618                | 125,458          | 127,076   | 75                                   |
| Real estate - commercial                | 1,356                    | -           | 1,356                | 250,533          | 251,889   | -                                    |
| Real estate - agricultural              | -                        | -           | -                    | 62,530           | 62,530    | -                                    |
| Commercial                              | 266                      | 204         | 470                  | 102,045          | 102,515   | -                                    |
| Agricultural                            | -                        | -           | -                    | 79,533           | 79,533    | -                                    |
| Consumer and other                      | 79                       | -           | 79                   | 21,520           | 21,599    | -                                    |
|   | \$3,012                  | \$ 511      | \$3,523              | \$707,887        | \$711,410 | \$ 75                                |

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The credit risk profile by internally assigned grade, on a disaggregated basis, as of September 30, 2016 and December 31, 2015 is as follows: (*in thousands*)

| <b>2016</b>          | Construction | Commercial  | Agricultural | Commercial | Agricultural | Total     |
|----------------------|--------------|-------------|--------------|------------|--------------|-----------|
|                      | Real Estate  | Real Estate | Real Estate  |            |              |           |
| Pass                 | \$ 54,485    | \$ 276,012  | \$ 52,055    | \$ 54,718  | \$ 54,473    | \$491,743 |
| Watch                | 3,055        | 20,084      | 11,669       | 15,095     | 20,751       | 70,654    |
| Special Mention      | -            | 590         | 4,228        | -          | 76           | 4,894     |
| Substandard          | 1,099        | 5,922       | 1,872        | 1,225      | 550          | 10,668    |
| Substandard-Impaired | -            | 431         | -            | 1,407      | 11           | 1,849     |
|                      | \$ 58,639    | \$ 303,039  | \$ 69,824    | \$ 72,445  | \$ 75,861    | \$579,808 |

| <b>2015</b>          | Construction | Commercial  | Agricultural | Commercial | Agricultural | Total     |
|----------------------|--------------|-------------|--------------|------------|--------------|-----------|
|                      | Real Estate  | Real Estate | Real Estate  |            |              |           |
| Pass                 | \$ 60,700    | \$ 227,425  | \$ 55,503    | \$ 91,096  | \$ 71,457    | \$506,181 |
| Watch                | 4,487        | 17,523      | 6,865        | 8,329      | 7,156        | 44,360    |
| Special Mention      | -            | 388         | -            | 224        | 81           | 693       |
| Substandard          | 1,081        | 5,995       | 162          | 2,669      | 828          | 10,735    |
| Substandard-Impaired | -            | 558         | -            | 197        | 11           | 766       |
|                      | \$ 66,268    | \$ 251,889  | \$ 62,530    | \$ 102,515 | \$ 79,533    | \$562,735 |

The credit risk profile based on payment activity, on a disaggregated basis, as of September 30, 2016 and December 31, 2015 is as follows:

| <b>2016</b>    | 1-4 Family              | Consumer  | Total      |
|----------------|-------------------------|-----------|------------|
|                | Residential Real Estate | and Other |            |
| Performing     | \$ 148,949              | \$ 20,988 | \$ 169,937 |
| Non-performing | 1,048                   | 85        | 1,133      |
|                | \$ 149,997              | \$ 21,073 | \$ 171,070 |

| <b>2015</b> | 1-4 Family              | Consumer  | Total |
|-------------|-------------------------|-----------|-------|
|             | Residential Real Estate | and Other |       |

|                |            |           |            |
|----------------|------------|-----------|------------|
| Performing     | \$ 125,951 | \$ 21,597 | \$ 147,548 |
| Non-performing | 1,125      | 2         | 1,127      |
|                | \$ 127,076 | \$ 21,599 | \$ 148,675 |

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## 8. Other Real Estate Owned

The following table provides the composition of other real estate owned as of September 30, 2016 and December 31, 2015: *(in thousands)*

|                                       | <b>2016</b>  | <b>2015</b>    |
|---------------------------------------|--------------|----------------|
| Construction and land development     | \$427        | \$739          |
| 1 to 4 family residential real estate | 227          | 511            |
|                                       | <b>\$654</b> | <b>\$1,250</b> |

The Company is actively marketing the assets referred to 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 Ames, Iowa area.

## 9. Goodwill

Goodwill is not amortized but is evaluated for impairment at least annually. For income tax purposes, goodwill is amortized over fifteen years.

## 10. Core deposit intangible asset

The following sets forth the carrying amounts and accumulated amortization of core deposit intangible assets at September 30, 2016 and December 31, 2015: *(in thousands)*

|                               | <b>2016</b>     |                             | <b>2015</b>     |                             |
|-------------------------------|-----------------|-----------------------------|-----------------|-----------------------------|
|                               | Gross<br>Amount | Accumulated<br>Amortization | Gross<br>Amount | Accumulated<br>Amortization |
| Core deposit intangible asset | \$2,518         | \$ 1,482                    | \$2,518         | \$ 1,209                    |

The weighted average life of the core deposit intangible is 3 years as of September 30, 2016 and December 31, 2015.



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The following sets forth the activity related to core deposit intangible assets for the three and nine months ended September 30, 2016 and 2015: *(in thousands)*

|  | <b>Three Months<br/>Ended<br/>September 30,<br/>2016</b> |         | <b>Nine Months<br/>Ended<br/>September 30,<br/>2015</b> |         |
|--|--|---------|---|---------|
| Beginning core deposit intangible, net | \$1,122  | \$1,507 | \$1,309   | \$1,730 |
| Amortization                           | (86 )  | (103 )  | (273 )  | (326 )  |
| Ending core deposit intangible, net    | \$1,036  | \$1,404 | \$1,036   | \$1,404 |

Estimated remaining amortization expense on core deposit intangible for the years ending December 31<sup>st</sup> is as follows:  
*(in thousands)*

|       |         |
|-------|---------|
| 2016  | \$80    |
| 2017  | 298     |
| 2018  | 251     |
| 2019  | 128     |
| 2020  | 71      |
| 2021  | 71      |
| After | 137     |
|       | \$1,036 |

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## 11. Secured Borrowings

The following sets forth the pledged collateral at estimated fair value related to securities sold under repurchase agreements and term repurchase agreements as of September 30, 2016 and December 31, 2015: *(in thousands)*

|   | 2016                   |   |                          | 2015                   |   |                          |
|---|------------------------|---|--------------------------|------------------------|---|--------------------------|
|   | Remaining<br>Overnight | Contractual<br>Greater<br>than<br>90 days | Maturity of the<br>Total | Remaining<br>Overnight | Contractual<br>Greater<br>than<br>90 days | Maturity of the<br>Total |
| Securities sold under agreements to repurchase: |                        |   |                          |                        |   |                          |
| U.S. government treasuries                      | \$1,505                | \$-                                       | \$1,505                  | \$1,467                | \$-                                       | \$1,467                  |
| U.S. government agencies                        | 47,673                 | -   | 47,673                   | 46,755                 | -   | 46,755                   |
| U.S. government mortgage-backed securities      | 33,214                 | -   | 33,214                   | 41,657                 | -   | 41,657                   |
| Total   | \$82,392               | \$-                                       | \$82,392                 | \$89,879               | \$-                                       | \$89,879                 |
| Term repurchase agreements (Other borrowings):  |                        |   |                          |                        |   |                          |
| U.S. government agencies                        | \$-                    | \$15,545                                  | \$15,545                 | \$-                    | \$12,503                                  | \$12,503                 |
| U.S. government mortgage-backed securities      | -                      | 395                                       | 395                      | -                      | 676                                       | 676                      |
| Total   | \$-                    | \$15,940                                  | \$15,940                 | \$-                    | \$13,179                                  | \$13,179                 |
| Total pledged collateral                        | \$82,392               | \$15,940                                  | \$98,332                 | \$89,879               | \$13,179                                  | \$103,058                |

In the event the repurchase agreements exceed the estimated fair value of the pledged securities available-for-sale, the Company has unpledged securities available-for-sale that may be pledged on the repurchase agreements.



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## 12.Regulatory Matters

The Company and the Banks capital amounts and ratios are as follows: (*dollars in thousands*)

|   | Actual     |        | For Capital Adequacy Purposes * |         | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|---|------------|--------|---------------------------------|---------|--|--------|
|   | Amount     | Ratio  | Amount                          | Ratio   | Amount   | Ratio  |
| As of September 30, 2016:                               |            |        |                                 |         |  |        |
| Total capital (to risk-weighted assets):                |            |        |                                 |         |  |        |
| Consolidated  | \$ 167,797 | 17.4 % | \$ 83,363                       | 8.625 % | N/A  | N/A    |
| Boone Bank & Trust                                      | 14,975     | 17.0   | 7,602                           | 8.625   | \$ 8,814   | 10.0 % |
| First National Bank                                     | 77,382     | 15.2   | 43,894                          | 8.625   | 50,891   | 10.0   |
| Reliance State Bank                                     | 25,642     | 14.6   | 15,125                          | 8.625   | 17,536   | 10.0   |
| State Bank & Trust                                      | 20,119     | 17.0   | 10,182                          | 8.625   | 11,805   | 10.0   |
| United Bank & Trust                                     | 14,930     | 20.0   | 6,435                           | 8.625   | 7,461  | 10.0   |
| Tier 1 capital (to risk-weighted assets):               |            |        |                                 |         |  |        |
| Consolidated  | \$ 156,827 | 16.3 % | \$ 64,033                       | 6.625 % | N/A  | N/A    |
| Boone Bank & Trust                                      | 14,046     | 15.9   | 5,839                           | 6.625   | \$ 7,051   | 8.0 %  |
| First National Bank                                     | 71,842     | 14.1   | 33,716                          | 6.625   | 40,713   | 8.0    |
| Reliance State Bank                                     | 23,692     | 13.5   | 11,617                          | 6.625   | 14,029   | 8.0    |
| State Bank & Trust                                      | 18,640     | 15.8   | 7,821                           | 6.625   | 9,444  | 8.0    |
| United Bank & Trust                                     | 14,163     | 19.0   | 4,943                           | 6.625   | 5,969  | 8.0    |
| Tier 1 capital (to average-weighted assets):            |            |        |                                 |         |  |        |
| Consolidated  | \$ 156,827 | 12.0 % | \$ 52,374                       | 4.000 % | N/A  | N/A    |
| Boone Bank & Trust                                      | 14,046     | 10.5   | 5,372                           | 4.000   | \$ 6,715   | 5.0 %  |
| First National Bank                                     | 71,842     | 10.1   | 28,566                          | 4.000   | 35,707   | 5.0    |
| Reliance State Bank                                     | 23,692     | 11.4   | 8,341                           | 4.000   | 10,426   | 5.0    |
| State Bank & Trust                                      | 18,640     | 12.2   | 6,122                           | 4.000   | 7,653  | 5.0    |
| United Bank & Trust                                     | 14,163     | 12.7   | 4,469                           | 4.000   | 5,586  | 5.0    |
| Common equity tier 1 capital (to risk-weighted assets): |            |        |                                 |         |  |        |
| Consolidated  | \$ 156,827 | 16.3 % | \$ 49,535                       | 5.125 % | N/A  | N/A    |
| Boone Bank & Trust                                      | 14,046     | 15.9   | 4,517                           | 5.125   | \$ 5,729   | 6.5 %  |
| First National Bank                                     | 71,842     | 14.1   | 26,082                          | 5.125   | 33,079   | 6.5    |
| Reliance State Bank                                     | 23,692     | 13.5   | 8,987                           | 5.125   | 11,398   | 6.5    |
| State Bank & Trust                                      | 18,640     | 15.8   | 6,050                           | 5.125   | 7,673  | 6.5    |

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|                     |        |      |       |       |       |     |
|---------------------|--------|------|-------|-------|-------|-----|
| United Bank & Trust | 14,163 | 19.0 | 3,824 | 5.125 | 4,850 | 6.5 |
|---------------------|--------|------|-------|-------|-------|-----|

\* These ratios for September 30, 2016 include a capital conservation buffer of 0.625%, except for the Tier 1 capital to average weighted assets ratios.

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|   | Actual    |        | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|---|-----------|--------|-------------------------------|-------|--|--------|
|   | Amount    | Ratio  | Amount                        | Ratio | Amount   | Ratio  |
| As of December 31, 2015:                                |           |        |                               |       |  |        |
| Total capital (to risk-weighted assets):                |           |        |                               |       |  |        |
| Consolidated  | \$157,926 | 16.6 % | \$76,179                      | 8.0 % | N/A  | N/A    |
| Boone Bank & Trust                                      | 14,525    | 15.5   | 7,477                         | 8.0   | \$9,346  | 10.0 % |
| First National Bank                                     | 74,210    | 15.3   | 38,859                        | 8.0   | 48,574   | 10.0   |
| Reliance State Bank                                     | 24,287    | 13.8   | 14,101                        | 8.0   | 17,626   | 10.0   |
| State Bank & Trust                                      | 19,658    | 16.2   | 9,729                         | 8.0   | 12,161   | 10.0   |
| United Bank & Trust                                     | 14,621    | 20.6   | 5,693                         | 8.0   | 7,116  | 10.0   |
| Tier 1 capital (to risk-weighted assets):               |           |        |                               |       |  |        |
| Consolidated  | \$147,430 | 15.5 % | \$57,134                      | 6.0 % | N/A  | N/A    |
| Boone Bank & Trust                                      | 13,569    | 14.5   | 5,608                         | 6.0   | \$7,477  | 8.0 %  |
| First National Bank                                     | 69,157    | 14.2   | 29,144                        | 6.0   | 38,859   | 8.0    |
| Reliance State Bank                                     | 22,491    | 12.8   | 10,575                        | 6.0   | 14,101   | 8.0    |
| State Bank & Trust                                      | 18,135    | 14.9   | 7,297                         | 6.0   | 9,729  | 8.0    |
| United Bank & Trust                                     | 13,858    | 19.5   | 4,269                         | 6.0   | 5,693  | 8.0    |
| Tier 1 capital (to average-weighted assets):            |           |        |                               |       |  |        |
| Consolidated  | \$147,430 | 11.3 % | \$52,657                      | 4.0 % | N/A  | N/A    |
| Boone Bank & Trust                                      | 13,569    | 9.8    | 5,557                         | 4.0   | \$6,946  | 5.0 %  |
| First National Bank                                     | 69,157    | 9.9    | 27,970                        | 4.0   | 34,963   | 5.0    |
| Reliance State Bank                                     | 22,491    | 10.7   | 8,380                         | 4.0   | 10,476   | 5.0    |
| State Bank & Trust                                      | 18,135    | 11.5   | 6,332                         | 4.0   | 7,915  | 5.0    |
| United Bank & Trust                                     | 13,858    | 12.5   | 4,452                         | 4.0   | 5,565  | 5.0    |
| Common equity tier 1 capital (to risk-weighted assets): |           |        |                               |       |  |        |
| Consolidated  | \$147,430 | 15.5 % | \$42,851                      | 4.5 % | N/A  | N/A    |
| Boone Bank & Trust                                      | 13,569    | 14.5   | 4,206                         | 4.5   | \$6,075  | 6.5 %  |
| First National Bank                                     | 69,157    | 14.2   | 21,858                        | 4.5   | 31,573   | 6.5    |
| Reliance State Bank                                     | 22,491    | 12.8   | 7,932                         | 4.5   | 11,457   | 6.5    |
| State Bank & Trust                                      | 18,135    | 14.9   | 5,473                         | 4.5   | 7,905  | 6.5    |
| United Bank & Trust                                     | 13,858    | 19.5   | 3,202                         | 4.5   | 4,625  | 6.5    |

The Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes in July 2013. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier I capital ratio, increase the minimum Tier 1 capital ratio

requirements and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The Company and the Banks have made the election to retain the existing treatment for accumulated other comprehensive income. The final rules took effect for the Company and the Banks on January 1, 2015, subject to a transition period for certain parts of the rules.

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Beginning in 2016, an additional capital conservation buffer was added to the minimum requirements for capital adequacy purposes, subject to a three year phase-in period. The capital conservation buffer will be fully phased-in on January 1, 2019 at 2.5 percent. A banking organization with a conservation buffer of less than 2.5 percent (or the required phase-in amount in years prior to 2019) will be subject to limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. At the present time, the ratios for the Company and the Banks are sufficient to meet the fully phased-in conservation buffer.

13. Subsequent Events

Management evaluated subsequent events through the date the financial statements were issued. There were no significant events or transactions occurring after September 30, 2016, but prior to November 8, 2016, that provided additional evidence about conditions that existed at September 30, 2016. There were no other significant events or transactions that provided evidence about conditions that did not exist at September 30, 2016.

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

**Overview**

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

The Company does not engage in any material business activities apart from its ownership of the Banks. Products and services offered by the Banks are for commercial and consumer purposes including loans, deposits and wealth management services. The Banks also offer investment services through a third-party broker-dealer. The Company employs thirteen individuals to assist with financial reporting, human resources, audit, compliance, marketing, technology systems and the coordination of management activities, in addition to 207 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 wealth management services provided by those Banks exercising trust powers; (iv) service fees on deposit accounts maintained at the Banks and (v) Merchant 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; (v) occupancy expenses for maintaining the Bank's facilities; and (vi) professional fees. 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 had net income of \$3,804,000, or \$0.41 per share, for the three months ended September 30, 2016, compared to net income of \$4,100,000, or \$0.44 per share, for the three months ended September 30, 2015.

The decrease in quarterly earnings can be primarily attributed to increased income tax expense, a higher provision for loan loss, and higher data processing costs, offset in part by higher loan interest income and lower security gains.

Net loan recoveries totaled \$81,000 and \$17,000 for the three months ended September 30, 2016 and 2015, respectively. The provision for loan losses totaled \$235,000 and \$38,000 for the three months ended September 30, 2016 and 2015, respectively.

The Company had net income of \$11,710,000, or \$1.26 per share, for the nine months ended September 30, 2016, compared to net income of \$11,100,000, or \$1.19 per share, for the nine months ended September 30, 2015.

The increase in year to date earnings can be primarily attributed to increased loan interest income, a lower provision for loan loss, and lower other real estate owned expenses, offset in part by lower net securities gains and an increase in salaries and benefits.

Net loan recoveries totaled \$22,000 for the nine months ended September 30, 2016 and net loan recoveries totaled \$51,000 for the nine months ended September 30, 2015. The provision for loan losses totaled \$441,000 and \$1,037,000 for the nine months ended September 30, 2016 and 2015, respectively.

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

Challenges

Key Performance Indicators and Industry Results

Critical Accounting Policies

Income Statement Review

Balance Sheet Review

Asset Quality Review and Credit Risk Management

Liquidity and Capital Resources

Forward-Looking Statements and Business Risks

## **Challenges**

Management has identified certain events or circumstances that may negatively impact the Company's financial condition and results of operations in the future and is attempting to position the Company to best respond to those challenges. These challenges are addressed in the Company's most recent Annual Report on Form 10-K filed on March 11, 2016.



Table Of Contents**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 6,058 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

|                     | <b>3 Months Ended September 30, 2016</b> |           | <b>9 Months Ended June 30, 2016</b> |           | <b>3 Months ended June 30, 2016</b> |           |         |           | <b>Years Ended December 31, 2015</b> |           |         |           | <b>2014</b> |           |  |  |
|---------------------|--|-----------|-------------------------------------|-----------|-------------------------------------|-----------|---------|-----------|--------------------------------------|-----------|---------|-----------|-------------|-----------|--|--|
|                     | Company                                  | Industry* | Company                             | Industry* | Company                             | Industry* | Company | Industry* | Company                              | Industry* | Company | Industry* | Company     | Industry* |  |  |
| Return on assets    | 1.15 %                                   | 1.18 %    | 1.23 %                              | 1.06 %    | 1.13 %                              | 1.04 %    | 1.21 %  | 1.01 %    |                                      |           |         |           |             |           |  |  |
| Return on equity    | 8.91 %                                   | 9.33 %    | 9.82 %                              | 9.45 %    | 9.44 %                              | 9.31 %    | 10.09 % | 9.03 %    |                                      |           |         |           |             |           |  |  |
| Net interest margin | 3.38 %                                   | 3.37 %    | 3.36 %                              | 3.08 %    | 3.33 %                              | 3.07 %    | 3.31 %  | 3.14 %    |                                      |           |         |           |             |           |  |  |
| Efficiency ratio    | 50.71 %                                  | 51.99 %   | 51.36 %                             | 57.74 %   | 53.59 %                             | 59.91 %   | 53.37 % | 61.88 %   |                                      |           |         |           |             |           |  |  |
| Capital ratio       | 12.85 %                                  | 12.62 %   | 12.51 %                             | 9.57 %    | 12.00 %                             | 9.59 %    | 12.05 % | 9.46 %    |                                      |           |         |           |             |           |  |  |

\*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 1.15% and 1.24% for the three months ended September 30, 2016 and 2015, respectively. The decrease in this ratio in 2016 from the previous period is primarily due to a decrease in net income associated with increased income tax expense, a higher provision for loan loss, lower security gains and higher data processing costs, offset in part by higher loan 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 return on average equity was at 8.91% and 10.35% for the three months ended September 30, 2016 and 2015, respectively. The decrease in this ratio in 2016 from the previous period is primarily due to an decrease in net income and an increase in average equity.

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Net Interest Margin

The net interest margin for the three months ended September 30, 2016 and 2015 was 3.38% and 3.36%, 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 2016 is primarily the result of an increase in the average balance of loans, offset in part by a decrease in the average balances of investment securities.

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 50.71% and 50.74% for the three months ended September 30, 2016 and 2015, respectively. The decrease in the efficiency ratio was due primarily to the increase in loan interest income.

Capital Ratio

The average capital ratio is calculated by dividing average total equity capital by average total assets. It measures the level of average assets that are funded by shareholders' equity. Given an equal level of risk in the financial condition of two companies, the higher the capital ratio, generally the more financially sound the company. The Company's capital ratio of 12.85% as of September 30, 2016 is significantly higher than the industry average as of June 30, 2016.

Industry Results

The FDIC Quarterly Banking Profile reported the following results for the second quarter of 2016:

Earnings Improvement Is Broad, Based

Expanding loan portfolios generated higher levels of net interest income, helping lift the total earnings of FDIC, insured commercial banks and savings institutions to \$43.6 billion in second quarter 2016. Industry net income was \$584 million (1.4%) higher than in second quarter 2015. The average return on assets (ROA) was 1.06%, down from 1.09% the year before, as asset growth outpaced the increase in quarterly net income. More than half of all banks, 60.1%, reported higher quarterly earnings compared with the year, earlier quarter, while the percentage of banks reporting negative quarterly net income fell to 4.5%, from 5.8% in second quarter 2015.

#### Net Interest Income Accounts for Most of the Growth in Revenue

Net operating revenue, the sum of net interest income and total noninterest income, totaled \$179.3 billion in the second quarter, an increase of \$5.8 billion (3.3%) from the year, earlier quarter. Net interest income was up \$5.2 billion (4.8%), as average interest, bearing assets were 4.4% higher than second quarter 2015. The average net interest margin of 3.08% was almost unchanged from the 3.07% average in second quarter 2015. Noninterest income was \$600 million (0.9%) higher than the year before. Trading income rose \$1.4 billion (24.9%), while servicing income fell by \$3.4 billion (74.4%).

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### Noninterest Expenses Decline at Many Large Banks

Noninterest expenses totaled \$104.8 billion, an increase of only \$271 million (0.3%) from the year, earlier quarter, as nonrecurring charges at several large banks declined by more than \$1.2 billion. In second quarter 2015, three large banks reported itemized litigation expenses totaling \$508 million. In the most recent quarter, one bank reported a \$473 million release of litigation reserves (a negative litigation expense), so the year, over, year reduction in litigation charges was \$981 million. In addition, charges for goodwill impairment were \$278 million lower than the year before. The declines in these noninterest expense items almost canceled out a \$1.4 billion (2.8%) year, over, year increase in salary and employee benefit expenses. Eight of the ten largest banks reported year, over, year declines in their total noninterest expenses, but for the industry as a whole, only 30% reported lower noninterest expenses.

### Loan, Loss Provisions Rise for the Eighth Consecutive Quarter

Banks set aside \$11.8 billion in loan, loss provisions in the second quarter, an increase of \$3.6 billion (44.2%) compared with second quarter 2015. More than a third of all banks, 38.7% reported higher loss provisions than in second quarter 2015. This is the eighth quarter in a row that quarterly loss provisions have posted a year, over, year increase.

### Charge, Offs of C&I Loans Post Further Increase

Net loan and lease charge, offs were higher than the year before for the third consecutive quarter. Charge, offs totaled \$10.1 billion, a \$1.2 billion (13.1%) increase over second quarter 2015. Fewer than half of all banks, 44.9% reported year, over, year increases in their quarterly net charge, offs. Most of the increase occurred in loans to commercial and industrial (C&I) borrowers. C&I net charge, offs rose to \$2.2 billion from \$1.1 billion a year earlier, an increase of \$1.1 billion (100.3%). This is the fifth consecutive quarter that C&I charge, offs have been higher than the year, earlier quarter. Banks reported smaller year, over, year increases in credit cards, auto loans, and agricultural production loans. The average net charge, off rate rose to 0.45%, from 0.42% in second quarter 2015.

### Total Noncurrent Loan Balances Decline, Although Noncurrent C&I Loans Rise

The amount of loans and leases that were noncurrent—90 days or more past due or in nonaccrual status—declined by \$4.8 billion (3.4%) during the second quarter. Noncurrent C&I loans increased for a sixth consecutive quarter, rising by \$2.1 billion (8.9%), but all other major loan categories registered quarterly declines in noncurrent balances. The

average noncurrent rate declined from 1.58% to 1.49% during the quarter. This is the lowest noncurrent rate for the industry since year, end 2007.

#### Banks Continue to Build Their Reserves

Insured institutions increased their reserves for loan losses by \$1 billion (0.8%) during the quarter, as the \$11.8 billion in loss provisions added to reserves exceeded the \$10.1 billion in net charge, offs subtracted from reserves. Banks with assets greater than \$1 billion, which also report their reserves for specific loan categories, increased their total reserves by \$987 million (0.9%). The largest increase was in reserves for credit card losses, which increased by \$1.3 billion (4.7%). They also increased their reserves for commercial loan losses by \$787 million (2.2%), while reducing their reserves for residential real estate losses by \$1.1 billion (5.1%). The increase in total reserves, combined with the reduction in total noncurrent loan balances, lifted the average coverage ratio of reserves to noncurrent loans from 85.5% to 89.2% during the quarter. The increase in reserves did not keep pace with the growth in total loan balances, however, as the average reserve ratio of reserves to total loans and leases fell from 1.35% to 1.33%. This is the 23rd time in the last 24 quarters that the industry's reserve ratio has declined, and it is now at its lowest level since year, end 2007.

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Internal Capital Generation Grows

Equity capital increased by \$30.4 billion (1.7%) in the quarter, as retained earnings contributed \$20.4 billion to capital growth and an increase in the market values of securities portfolios added to total equity. Retained earnings were \$6.7 billion (49.2%) higher than the year before, as banks reduced their quarterly dividends by \$6.1 billion (20.9%), compared with second quarter 2015 levels. Accumulated other comprehensive income, which includes changes in the values of banks' available, for, sale securities, increased by \$9.7 billion during the quarter. At the end of the second quarter, more than 99% of all banks, representing 99.9% of total industry assets, met or exceeded the requirements for well, capitalized banks as defined for Prompt Corrective Action purposes.

Loan Growth Remains Strong

Total assets increased by \$240.6 billion (1.5%) during the quarter. Total loan and lease balances rose by \$181.9 billion (2%). The largest increases occurred in residential mortgages (up \$42.4 billion, 2.2%), real estate loans secured by nonfarm nonresidential properties (up \$26.9 billion, 2.1%), credit card balances (up \$22.3 billion, 3.1%), and loans to nondepository financial institutions (up \$19.8 billion, 6.9%). All major loan categories saw increases in balances outstanding during the second quarter. For the 12 months ended June 30, total loans and leases increased 6.7%, down slightly from 6.9% for the 12 months ended March 31. In addition to the growth in loan balances, banks increased their unfunded loan commitments by \$36.4 billion (0.5%). This is the smallest quarterly increase in unfunded commitments since fourth quarter 2013. For a second consecutive quarter, unfunded commitments to make C&I loans declined, falling by \$24.1 billion (1.3%). Banks' investments in securities rose by \$36.1 billion (1.1%), with \$28.7 billion of the growth coming from increased holdings of mortgage, backed securities. Balances with Federal Reserve banks declined by \$90.6 billion (7.2%).

Banks Increase Borrowings From Federal Home Loan Banks

Nondeposit liabilities funded a larger share of asset growth than deposits in the second quarter. These borrowings rose by \$111.7 billion (5.5%), as advances from Federal Home Loan Banks increased by \$64.4 billion (13.4%). Total deposits increased by \$98.6 billion (0.8%). Deposits in domestic offices rose by \$94.8 billion (0.9%), while foreign office deposits increased \$3.8 billion (0.3%). Interest, bearing domestic office deposits were up \$52.2 billion (0.6%), while balances in noninterest, bearing accounts rose by \$42.5 billion (1.4%). At banks that offer consumer deposit accounts (checking or savings accounts intended primarily for individuals for personal, household, or family use), balances in these accounts declined by \$13 billion (0.3%) during the quarter. At banks with assets greater than \$1 billion that offer consumer accounts, quarterly service charge income on these accounts increased by \$35 million (0.8%) from the year before.

'Problem List' Shrinks to 147 Institutions

The number of FDIC, insured commercial banks and savings institutions reporting quarterly financial results declined to 6,058 from 6,122 in the second quarter. During the quarter, mergers absorbed 57 insured institutions, two banks failed, and no new charters were added. The number of banks on the FDIC's "Problem List" declined from 165 to 147, and total assets of problem banks fell from \$30.9 billion to \$29 billion. This is the smallest number of problem banks in eight years. Banks reported 2,045,221 full, time equivalent employees in the quarter, an increase of 5,302 compared with the first quarter, and 2,816 more than in second quarter 2015.



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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, 2015 consolidated financial statements. These statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The financial information contained in these statements is, for the most part, based on the financial effects of transactions and events that have already occurred. However, the preparation of these statements requires management to make certain estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses.

The Company's significant accounting policies are described in the "Notes to Consolidated Financial Statements" accompanying the Company's audited financial statements. Based on its consideration of accounting policies that involve the most complex and subjective estimates and judgments, management has identified the allowance for loan losses, the assessment of other-than-temporary impairment for investment securities and the assessment of goodwill to be the Company's most critical accounting policies.

**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 various considerations regarding 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 changes 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.

For further discussion concerning the allowance for loan losses and the process of establishing specific reserves, see the section of this Annual Report entitled "Asset Quality Review and Credit Risk Management" and "Analysis of the Allowance for Loan Losses".

**Fair Value and Other-Than-Temporary Impairment of Investment Securities**

The Company's securities available-for-sale portfolio is carried at fair value with "fair value" being defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability is not adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact, and (iv) willing to transact.

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

Goodwill

Goodwill arose in connection with two acquisitions consummated in previous periods. Goodwill is 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. Impairment would arise if the fair value of a reporting unit is less than its carrying value. At September 30, 2016, Company's management has completed the goodwill impairment assessment and determined goodwill was not impaired. Actual future test results may differ from the present evaluation of impairment due to changes in the conditions used in the current evaluation.

Table Of Contents**Income Statement Review for the Three Months ended September 30, 2016 and 2015**

The following highlights a comparative discussion of the major components of net income and their impact for the three months ended September 30, 2016 and 2015:

**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**

|   | <b>Three Months Ended September 30,</b> |                     |                |                    |                     |                |
|---|---|---------------------|----------------|--------------------|---------------------|----------------|
|   | <b>2016</b>                             |                     |                | <b>2015</b>        |                     |                |
|   | Average<br>balance                      | Revenue/<br>expense | Yield/<br>rate | Average<br>balance | Revenue/<br>expense | Yield/<br>rate |
| <b>ASSETS</b>   |   |                     |                |                    |                     |                |
| <i>(dollars in thousands)</i>                               |   |                     |                |                    |                     |                |
| Interest-earning assets                                     |   |                     |                |                    |                     |                |
| Loans 1   |   |                     |                |                    |                     |                |
| Commercial  | \$88,265                                | \$ 1,014            | 4.59 %         | \$101,382          | \$ 1,124            | 4.44 %         |
| Agricultural  | 73,879                                  | 900                 | 4.87 %         | 77,403             | 914                 | 4.72 %         |
| Real estate   | 555,002                                 | 6,131               | 4.42 %         | 490,282            | 5,585               | 4.56 %         |
| Consumer and other  | 21,513                                  | 191                 | 3.56 %         | 19,505             | 185                 | 3.80 %         |
| Total loans (including fees)                                | 738,659                                 | 8,236               | 4.46 %         | 688,572            | 7,808               | 4.54 %         |
| Investment securities                                       |   |                     |                |                    |                     |                |
| Taxable   | 259,212                                 | 1,425               | 2.20 %         | 276,205            | 1,507               | 2.18 %         |
| Tax-exempt 2  | 249,400                                 | 2,045               | 3.28 %         | 261,882            | 2,205               | 3.37 %         |
| Total investment securities                                 | 508,612                                 | 3,470               | 2.73 %         | 538,087            | 3,712               | 2.76 %         |
| Interest bearing deposits with banks and federal funds sold | 25,533                                  | 87                  | 1.36 %         | 38,397             | 94                  | 0.98 %         |
| Total interest-earning assets                               | 1,272,804                               | \$ 11,793           | 3.71 %         | 1,265,056          | \$ 11,614           | 3.67 %         |

|                            |             |             |
|----------------------------|-------------|-------------|
| Noninterest-earning assets | 55,732      | 55,804      |
| TOTAL ASSETS               | \$1,328,536 | \$1,320,860 |

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

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

Table Of Contents**AVERAGE BALANCE SHEETS AND INTEREST RATES**

|   | <b>Three Months Ended September 30,</b> |                     |                |                    |                     |                |
|---|---|---------------------|----------------|--------------------|---------------------|----------------|
|   | <b>2016</b>                             |                     |                | <b>2015</b>        |                     |                |
|   | Average<br>balance                      | Revenue/<br>expense | Yield/<br>rate | Average<br>balance | Revenue/<br>expense | Yield/<br>rate |
| <b>LIABILITIES AND STOCKHOLDERS'<br/>EQUITY</b>       |   |                     |                |                    |                     |                |
| <i>(dollars in thousands)</i>                         |   |                     |                |                    |                     |                |
| Interest-bearing liabilities                          |   |                     |                |                    |                     |                |
| Deposits  |   |                     |                |                    |                     |                |
| NOW, savings accounts and money markets               | \$658,522                               | \$ 325              | 0.20 %         | \$655,533          | \$ 288              | 0.18 %         |
| Time deposits > \$100,000                             | 84,034                                  | 196                 | 0.93 %         | 89,196             | 199                 | 0.89 %         |
| Time deposits < \$100,000                             | 123,648                                 | 233                 | 0.75 %         | 136,131            | 258                 | 0.76 %         |
| Total deposits  | 866,204                                 | 754                 | 0.35 %         | 880,860            | 745                 | 0.34 %         |
| Other borrowed funds                                  | 94,504                                  | 274                 | 1.16 %         | 81,583             | 258                 | 1.26 %         |
| Total Interest-bearing liabilities                    | 960,708                                 | 1,028               | 0.43 %         | 962,443            | 1,003               | 0.42 %         |
| Noninterest-bearing liabilities                       |   |                     |                |                    |                     |                |
| Demand deposits                                       | 188,419                                 |                     |                | 193,518            |                     |                |
| Other liabilities                                     | 8,710                                   |                     |                | 6,431              |                     |                |
| Stockholders' equity                                  | 170,699                                 |                     |                | 158,468            |                     |                |
| <b>TOTAL LIABILITIES AND<br/>STOCKHOLDERS' EQUITY</b> | <b>\$1,328,536</b>                      |                     |                | <b>\$1,320,860</b> |                     |                |
| Net interest income                                   |   | \$ 10,765           | 3.38 %         |                    | \$ 10,611           | 3.36 %         |
| Spread Analysis                                       |   |                     |                |                    |                     |                |
| Interest income/average assets                        | \$11,793                                | 3.55 %              |                | \$11,614           | 3.52 %              |                |
| Interest expense/average assets                       | \$1,028                                 | 0.31 %              |                | \$1,003            | 0.30 %              |                |
| Net interest income/average assets                    | \$10,765                                | 3.24 %              |                | \$10,611           | 3.21 %              |                |

## Net Interest Income

For the three months ended September 30, 2016 and 2015, the Company's net interest margin adjusted for tax exempt income was 3.38% and 3.36%, respectively. Net interest income, prior to the adjustment for tax-exempt income, for the three months ended September 30, 2016 totaled \$10,050,000 compared to \$9,840,000 for the three months ended September 30, 2015.

For the three months ended September 30, 2016, interest income increased \$235,000, or 2%, when compared to the same period in 2015. The increase from 2015 was primarily attributable to higher average balance of loans, offset in part by lower average balances of investment securities. The higher average balances of loans were due primarily to favorable economic conditions that fueled loan demand over much of the past year. The lower average balances of investments were primarily due to normal maturities and calls and to a lesser extent sales.

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Interest expense increased \$25,000, or 3%, for the three months ended September 30, 2016 when compared to the same period in 2015. The higher interest expense for the period is primarily attributable to an increase in average balance of other borrowed funds.

### Provision for Loan Losses

The Company's provision for loan losses was \$235,000 and \$38,000 for the three months ended September 30, 2016 and 2015, respectively. Net loan recoveries were \$81,000 and \$17,000 for the three months ended September 30, 2016 and 2015, respectively. The loan portfolio credit quality gauged by 90 day past due loans and total impaired loans remains favorable in comparison to our peers. However, the agricultural economy has weakened as declining grain prices have caused lower profitability for our agricultural borrowers.

### Noninterest Income and Expense

Noninterest income increased \$54,000 for the three months ended September 30, 2016 compared to the same period in 2015. The increase in noninterest income is primarily due to higher gains on the sale of loans held for sale. This increase in gain of the sale of loans is due primarily to increase in loan volume due to the continued low interest rate environment. Exclusive of realized securities gains, noninterest income was 5% higher in the third quarter of 2016 compared to the same period in 2015.

Noninterest expense increased \$130,000 or 2% for the three months ended September 30, 2016 compared to the same period in 2015 primarily as a result of an increase in salaries and employee benefits and data processing costs. This increase in salaries and employee benefits are mainly due to normal salary increases. The increase in data processing expenses are mainly due to increasing costs on new and existing technology items. The efficiency ratio for the third quarter of 2016 was 50.71%, compared to 50.74% in 2015.

### Income Taxes

The provision for income taxes expense for the three months ended September 30, 2016 and 2015 was \$1,903,000 and \$1,670,000, respectively, representing an effective tax rate of 33% and 29%, respectively. The increase is mainly due to the Company recording a \$226,000 valuation allowance to fully reserve the deferred income tax asset associated with a state alternative minimum tax ("AMT") credit carryforward, as management believes it is more likely than not that such carryforward will not be utilized.





Table Of Contents**Income Statement Review for the Nine Months ended September 30, 2016 and 2015**

The following highlights a comparative discussion of the major components of net income and their impact for the nine months ended September 30, 2016 and 2015:

**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**

|   | <b>Nine Months Ended September 30,</b> |                     |                |                    |                     |                |
|---|--|---------------------|----------------|--------------------|---------------------|----------------|
|   | <b>2016</b>                            |                     |                | <b>2015</b>        |                     |                |
|   | Average<br>balance                     | Revenue/<br>expense | Yield/<br>rate | Average<br>balance | Revenue/<br>expense | Yield/<br>rate |
| <b>ASSETS</b>   |  |                     |                |                    |                     |                |
| <i>(dollars in thousands)</i>                               |  |                     |                |                    |                     |                |
| Interest-earning assets                                     |  |                     |                |                    |                     |                |
| Loans 1   |  |                     |                |                    |                     |                |
| Commercial  | \$94,121                               | \$ 3,192            | 4.52 %         | \$97,028           | \$ 3,305            | 4.54 %         |
| Agricultural  | 75,211                                 | 2,754               | 4.88 %         | 76,044             | 2,689               | 4.71 %         |
| Real estate   | 528,179                                | 17,595              | 4.44 %         | 485,392            | 16,394              | 4.50 %         |
| Consumer and other  | 21,897                                 | 584                 | 3.56 %         | 17,766             | 532                 | 3.99 %         |
| Total loans (including fees)                                | 719,408                                | 24,125              | 4.47 %         | 676,230            | 22,920              | 4.52 %         |
| Investment securities                                       |  |                     |                |                    |                     |                |
| Taxable   | 262,604                                | 4,393               | 2.23 %         | 276,287            | 4,639               | 2.24 %         |
| Tax-exempt 2  | 253,688                                | 6,335               | 3.33 %         | 264,631            | 6,766               | 3.41 %         |
| Total investment securities                                 | 516,292                                | 10,728              | 2.77 %         | 540,918            | 11,405              | 2.81 %         |
| Interest bearing deposits with banks and federal funds sold | 34,930                                 | 297                 | 1.13 %         | 46,608             | 288                 | 0.83 %         |
| Total interest-earning assets                               | 1,270,630                              | \$ 35,150           | 3.69 %         | 1,263,756          | \$ 34,613           | 3.65 %         |

|                            |             |             |
|----------------------------|-------------|-------------|
| Noninterest-earning assets | 54,989      | 61,607      |
| TOTAL ASSETS               | \$1,325,619 | \$1,325,363 |

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

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

Table Of Contents**AVERAGE BALANCE SHEETS AND INTEREST RATES**

|   | <b>Nine Months Ended September 30,</b> |                     |                |                    |                     |                |
|---|--|---------------------|----------------|--------------------|---------------------|----------------|
|   | <b>2016</b>                            |                     |                | <b>2015</b>        |                     |                |
|   | Average<br>balance                     | Revenue/<br>expense | Yield/<br>rate | Average<br>balance | Revenue/<br>expense | Yield/<br>rate |
| <b>LIABILITIES AND STOCKHOLDERS'<br/>EQUITY</b>       |  |                     |                |                    |                     |                |
| <i>(dollars in thousands)</i>                         |  |                     |                |                    |                     |                |
| Interest-bearing liabilities                          |  |                     |                |                    |                     |                |
| Deposits  |  |                     |                |                    |                     |                |
| NOW, savings accounts and money markets               | \$663,891                              | \$965               | 0.19 %         | \$651,101          | \$847               | 0.17 %         |
| Time deposits > \$100,000                             | 86,632                                 | 590                 | 0.91 %         | 90,706             | 613                 | 0.90 %         |
| Time deposits < \$100,000                             | 125,745                                | 704                 | 0.75 %         | 140,515            | 816                 | 0.77 %         |
| Total deposits  | 876,268                                | 2,259               | 0.34 %         | 882,322            | 2,276               | 0.34 %         |
| Other borrowed funds                                  | 84,261                                 | 796                 | 1.26 %         | 86,535             | 899                 | 1.38 %         |
| Total Interest-bearing liabilities                    | 960,529                                | 3,055               | 0.42 %         | 968,857            | 3,175               | 0.44 %         |
| Noninterest-bearing liabilities                       |  |                     |                |                    |                     |                |
| Demand deposits                                       | 190,176                                |                     |                | 191,685            |                     |                |
| Other liabilities                                     | 7,606                                  |                     |                | 6,643              |                     |                |
| Stockholders' equity                                  | 167,308                                |                     |                | 158,178            |                     |                |
| <b>TOTAL LIABILITIES AND<br/>STOCKHOLDERS' EQUITY</b> | <b>\$1,325,619</b>                     |                     |                | <b>\$1,325,363</b> |                     |                |
| Net interest income                                   |  | \$32,095            | 3.37 %         |                    | \$31,438            | 3.32 %         |
| Spread Analysis                                       |  |                     |                |                    |                     |                |
| Interest income/average assets                        | \$35,150                               | 3.54 %              |                | \$34,613           | 3.48 %              |                |
| Interest expense/average assets                       | \$3,055                                | 0.31 %              |                | \$3,175            | 0.32 %              |                |
| Net interest income/average assets                    | \$32,095                               | 3.23 %              |                | \$31,438           | 3.16 %              |                |

## Net Interest Income

For the nine months ended September 30, 2016 and 2015, the Company's net interest margin adjusted for tax exempt income was 3.37% and 3.32%, respectively. Net interest income, prior to the adjustment for tax-exempt income, for the nine months ended September 30, 2016 totaled \$29,877,000 compared to \$29,073,000 for the nine months ended September 30, 2015.

Interest income increased \$685,000, or 2% for the nine months ended September 30, 2016, when compared to the same period in 2015. The increase from 2015 was primarily attributable to higher average balance of loans, offset in part by lower average balances of investment securities. The higher average balances of loans were due primarily to favorable economic conditions that fueled loan demand over much of the past year. The lower average balances of investments were primarily due to normal maturities and calls and to a lesser extent sales.

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Interest expense decreased \$119,000, or 4%, for the nine months ended September 30, 2016 when compared to the same period in 2015. The lower interest expense for the period is primarily attributable lower average rates on borrowed funds. This decrease in the average rate of other borrowed funds is primarily due to the repayment of loans related to financing agreements in 2016 and higher balances of overnight FHLB advances.

### Provision for Loan Losses

The Company's provision for loan losses was \$441,000 and \$1,037,000 for the nine months ended September 30, 2016 and 2015, respectively. Net loan recoveries were \$22,000 and \$51,000 for the nine months ended September 30, 2016 and 2015, respectively. The growth in the loan portfolio and a specific reserve on a newly impaired loan were the primary factors driving the provision for loan losses in 2016. The growth in the loan portfolio was a primary factor for the provision for loan losses in 2015.

### Noninterest Income and Expense

Noninterest income decreased \$94,000 for the nine months ended September 30, 2016 compared to the same period in 2015. The decrease in noninterest income is primarily due to lower realized securities gains of \$313,000, offset in part by higher wealth management income of \$169,000 compared to the prior year. The increase in wealth management income is due primarily to increases in estate fees. Exclusive of realized securities gains, noninterest income was 4% higher in the nine months ended September 30, 2016 compared to the same period in 2015.

Noninterest expense decreased \$146,000 or 1% for the nine months ended September 30, 2016 compared to the same period in 2015 primarily as a result of lower other real estate owned expenses of \$693,000. This decrease is primarily due to an impairment write down in 2015. Offsetting this decrease in expenses is a 4% increase in salaries and employee benefits. This increase is mainly due to normal salary increases along with costs associated with additional lending and support staff. The efficiency ratio for the nine months ended September 30, 2016 was 51.99%, compared to 53.45% for the nine months ended September 30, 2015.

### Income Taxes

The provision for income taxes expense for the nine months ended September 30, 2016 and 2015 was \$5,087,000 and \$4,246,000, respectively, representing an effective tax rate of 30% and 28%, respectively. The increase in effective rate is due primarily to the impact of a lower level of tax-exempt interest income in 2016 compared to 2015 and the

recording of a valuation reserve on a state AMT credit carryforward. The Company recorded a \$226,000 valuation allowance to fully reserve the deferred income tax asset associated with a state AMT credit carryforward, as management believes it is more likely than not that such carryforward will not be utilized.

### **Balance Sheet Review**

As of September 30, 2016, total assets were \$1,340,344,000, a \$13,597,000 increase compared to December 31, 2015. The increase in assets was due primarily to an increase in loans, offset in part by a decrease in securities.

### **Investment Portfolio**

The investment portfolio totaled \$517,579,000 as of September 30, 2016, a decrease of \$20,054,000 or 4% from the December 31, 2015 balance of \$537,633,000. The decrease in the investment portfolio was primarily due to sales, maturities and pay downs of state and political subdivision bonds and U.S. government mortgage-backed securities.

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On a quarterly basis, the investment portfolio is reviewed for other-than-temporary impairment. As of September 30, 2016, gross unrealized losses of \$363,000, are considered to be temporary in nature due to the interest rate environment of 2016 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.

At September 30, 2016, the Company's investment securities portfolio included securities issued by 270 government municipalities and agencies located within 24 states with a fair value of \$266.5 million. At December 31, 2015, the Company's investment securities portfolio included securities issued by 283 government municipalities and agencies located within 24 states with a fair value of \$277.6 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 as of September 30, 2016 was \$5.1 million (approximately 1.9 % of the fair value of the governmental municipalities and agencies) represented by the Dubuque, 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.



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The following table summarizes the total general obligation and revenue bonds in the Company's investment securities portfolios as of September 30, 2016 and December 31, 2015 identifying the state in which the issuing government municipality or agency operates. *(Dollars in thousands)*

|   | <b>2016</b>      |                      | <b>2015</b>      |                      |
|---|------------------|----------------------|------------------|----------------------|
|   | Amortized Cost   | Estimated Fair Value | Amortized Cost   | Estimated Fair Value |
| Obligations of states and political subdivisions:             |                  |                      |                  |                      |
| General Obligation bonds:                                     |                  |                      |                  |                      |
| Iowa  | \$69,987         | \$70,825             | \$77,735         | \$78,255             |
| Texas   | 11,124           | 11,388               | 10,712           | 10,967               |
| Pennsylvania  | 8,730            | 8,869                | 8,389            | 8,448                |
| Washington  | 7,249            | 7,303                | 2,652            | 2,644                |
| Other (2016: 16 states; 2015: 15 states)                      | 26,744           | 27,402               | 32,198           | 32,782               |
| <b>Total general obligation bonds</b>                         | <b>\$123,834</b> | <b>\$125,787</b>     | <b>\$131,686</b> | <b>\$133,096</b>     |
| Revenue bonds:  |                  |                      |                  |                      |
| Iowa  | \$130,209        | \$132,687            | \$134,333        | \$136,705            |
| Other (2016: 9 states; 2015: 9 states)                        | 7,938            | 8,061                | 7,752            | 7,796                |
| <b>Total revenue bonds</b>                                    | <b>\$138,147</b> | <b>\$140,748</b>     | <b>\$142,085</b> | <b>\$144,501</b>     |
| <b>Total obligations of states and political subdivisions</b> | <b>\$261,981</b> | <b>\$266,535</b>     | <b>\$273,771</b> | <b>\$277,597</b>     |

As of September 30, 2016 and December 31, 2015, 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 primarily 8 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. *(in thousands)*

|  | <b>2016</b>    |                      | <b>2015</b>    |                      |
|--|----------------|----------------------|----------------|----------------------|
|  | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Revenue bonds by revenue source                        |                |                      |                |                      |
| Sales tax  | \$77,157       | \$79,074             | \$88,299       | \$90,145             |
| Water  | 14,115         | 14,286               | 10,446         | 10,548               |
| College and universities, primarily dormitory revenues | 11,287         | 11,473               | 12,153         | 12,298               |

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|                                       |           |           |           |           |
|---------------------------------------|-----------|-----------|-----------|-----------|
| Leases                                | 8,820     | 8,934     | 9,900     | 9,939     |
| Electric                              | 8,714     | 8,921     | 8,950     | 9,141     |
| Other                                 | 18,054    | 18,060    | 12,337    | 12,430    |
| Total revenue bonds by revenue source | \$138,147 | \$140,748 | \$142,085 | \$144,501 |

Loan Portfolio

The loan portfolio, net of the allowance for loan losses of \$10,451,000, totaled \$740,322,000 as of September 30, 2016, an increase of \$38,994,000, or 6%, from the December 31, 2015 balance of \$701,328,000. The increase in the loan portfolio is primarily due to steady loan demand for most of our affiliate banks. The Company's expansion into the Des Moines metro market was a significant factor in obtaining this growth.

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Other Real Estate Owned

Other real estate owned was \$654,000 as of September 30, 2016, compared to \$1,250,000 as of December 31, 2015, respectively.

Deposits

Deposits totaled \$1,061,809,000 as of September 30, 2016, a decrease of \$12,384,000, or 1%, from the December 31, 2015 balance of \$1,074,193,000. The decrease in deposits was primarily due to a decrease in demand deposits and other time deposits balances, offset in part by an increase in money market account balances.

Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase totaled \$49,858,000 as of September 30, 2016, a decrease of \$4,432,000, or 8%, from the December 31, 2015 balance of \$54,290,000 associated with two commercial accounts.

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, 2015.

**Asset Quality Review and Credit Risk Management**

The Company's credit risk is historically centered in the loan portfolio, which on September 30, 2016 totaled \$740,322,000 compared to \$701,328,000 as of December 31, 2015. Net loans comprise 55.2% of total assets as of September 30, 2016. 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 0.40% at September 30, 2016, as compared to 0.24% at December 31, 2015 and 0.28% at September 30, 2015. The Company's level of problem loans as a percentage of total loans at September 30, 2016 of 0.40% is lower than the Company's peer group (339 bank holding companies with assets of \$1 billion to \$3 billion) of 0.84% as of June 30, 2016.

Impaired loans, net of specific reserves, totaled \$2,264,000 as of September 30, 2016 and have increased \$885,000 as compared to the impaired loans of \$1,379,000 as of December 31, 2015. The increase in impaired loans since December 31, 2015 is primarily due to a deterioration of two credit relationships in the commercial operating portfolio.

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.

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The Company had TDRs of \$1,388,000 as of September 30, 2016, of which all were included in impaired loans and on nonaccrual status. The Company had TDRs of \$780,000 as of December 31, 2015, all of which were included in impaired and nonaccrual loans.

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, recognize impairment through the allowance. The Company had no charge-off related to TDRs for the nine months ended September 30, 2016 and 2015.

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 September 30, 2016, non-accrual loans totaled \$2,981,000 and there were no loan past due 90 days and still accruing. This compares to non-accrual loans of \$1,815,000 and loans past due 90 days and still accruing totaled \$75,000 as of December 31, 2015. Other real estate owned totaled \$654,000 as of September 30, 2016 and \$1,250,000 as of December 31, 2015.

The agricultural real estate and agricultural operating loan portfolio classifications have weakened. The watch and special mention loans in these categories are \$36,724,000 as of September 30, 2016 as compared to \$14,102,000 as of December 31, 2015. The increase in these categories is primarily due to low grain prices, partially offset by favorable yields.

The allowance for loan losses as a percentage of outstanding loans as of September 30, 2016 was 1.39%, as compared to 1.40% at December 31, 2015. The allowance for loan losses totaled \$10,451,000 and \$9,988,000 as of September 30, 2016 and December 31, 2015, respectively. Net recoveries of loans totaled \$22,000 for the nine months ended September 30, 2016 as compared to net recoveries of loans of \$51,000 for the nine months ended September 30, 2015.

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.

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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 September 30, 2016, 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

Liquid assets of cash and due from banks and interest-bearing deposits in financial institutions as of September 30, 2016 and December 31, 2015 totaled \$47,304,000 and \$50,999,000, respectively, and provide an adequate level of liquidity given current economic conditions.

Other sources of liquidity available to the Banks as of September 30, 2016 include outstanding lines of credit with the FHLB of Des Moines, Iowa of \$188,726,000, with \$38,000,000 of outstanding FHLB advances. Federal funds borrowing capacity at correspondent banks was \$107,172,000, with no outstanding federal fund purchase balances as of September 30, 2016. The Company had securities sold under agreements to repurchase totaling \$49,858,000 and term repurchase agreements of \$13,000,000 as of September 30, 2016.

Total investments as of September 30, 2016 were \$517,579,000 compared to \$537,633,000 as of December 31, 2015. These investments provide the Company with a significant amount of liquidity since all of the investments are classified as available-for-sale as of September 30, 2016.

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 and payments represent a significant source of liquidity.

#### Review of Statements of Cash Flows

Net cash provided by operating activities for the nine months ended September 30, 2016 totaled \$14,585,000 compared to the \$15,906,000 for the nine months ended September 30, 2015. The decrease of \$1,321,000 in net cash provided by operating activities was primarily due to changes in loans held for sale and other real estate owned.



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Net cash used in investing activities for the nine months ended September 30, 2016 was \$14,181,000 compared to \$44,038,000 for the nine months ended September 30, 2015. The decrease of \$29,858,000 in cash used in investing activities was primarily due to a lower level of purchases of securities available-for-sale of \$49,668,000 in 2016 compared to \$87,375,000 in 2015.

Net cash provided by (used in) financing activities for the nine months ended September 30, 2016 totaled \$(3,105,000) compared to \$30,543,000 for the nine months ended September 30, 2015. The change of \$33,648,000 in net cash (used in) financing activities was primarily due to a decrease in deposits in 2016 of \$12,358,000 as compared to an increase in deposits of \$9,357,000 in 2015. To a lesser extent, the change was also due to the net proceeds from the FHLB borrowings of \$19,458,000 in 2016 compared to \$25,786,000 in 2015. As of September 30, 2016, 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 Banks provide adequate liquidity to pay the Company's expenses and stockholder dividends. Dividends paid by the Banks to the Company amounted to \$6,825,000 and \$6,200,000 for the nine months ended September 30, 2016 and 2015, respectively. 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 \$0.21 per share in 2016 from \$0.20 per share in 2015.

The Company, on an unconsolidated basis, has interest bearing deposits totaling \$10,546,000 as of September 30, 2016 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

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 September 30, 2016 that are of concern to management.

#### Capital Resources

The Company's total stockholders' equity as of September 30, 2016 totaled \$170,737,000 and was \$9,487,000 higher than the \$161,250,000 recorded as of December 31, 2015. The increase in stockholders' equity was primarily due to net income and an increase in accumulated other comprehensive income, reduced by dividends declared. The increase in other comprehensive income is created by 2016 market interest rates trending lower, which resulted in higher fair values in the securities available-for-sale portfolio. At September 30, 2016 and December 31, 2015, stockholders' equity as a percentage of total assets was 12.74% and 12.15%, respectively. The capital levels of the Company exceed applicable regulatory guidelines as of September 30, 2016.

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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; 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 2016 changed significantly when compared to 2015.

**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, 2015, 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 September 30, 2016, 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 September 30, 2016.

| 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 |
|--------|---|--|--|--|
|        |   |  |  |  |

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|   |   |    |   |   |         |
|---|---|----|---|---|---------|
| July 1, 2016 to July 31, 2016           | - | \$ | - | - | 100,000 |
| August 1, 2016 to August 31, 2016       | - | \$ | - | - | 100,000 |
| September 1, 2016 to September 30, 2016 | - | \$ | - | - | 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

- 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.INSXBRL Instance Document (1)
- 101.SCHXBRL Taxonomy Extension Schema Document (1)
- 101.CALXBRL Taxonomy Extension Calculation Linkbase Document (1)
- 101.LABXBRL Taxonomy Extension Label Linkbase Document (1)
- 101.PREXBRL 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: November 8, 2016

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

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