

PHELPS DODGE CORP  
Form 10-K  
March 07, 2005

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-K**

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

**For the fiscal year ended December 31, 2004**

**OR**

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

**For the transition period \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 1-82**

**PHELPS DODGE CORPORATION**

(Exact name of registrant as specified in its charter)

**New York**  
(State or other jurisdiction of  
incorporation or organization)

**13-1808503**  
(I.R.S. Employer  
Identification No.)

**One North Central Avenue, Phoenix, AZ**  
(Address of principal executive offices)

**85004-4414**  
(Zip Code)

Registrant's telephone number, including area code: (602) 366-8100

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

Title of each class	Name of each exchange on which registered
Common Shares, \$6.25 par value per share	New York Stock Exchange
Mandatory Convertible Preferred Shares, \$1.00 par value per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No .

The aggregate market value of Common Shares of the issuer held by nonaffiliates at June 30, 2004, was approximately \$7,267,372,169.

Number of Common Shares outstanding at March 3, 2005: 96,660,599 shares.

Documents Incorporated by Reference:

Document	Location in 10-K
Proxy Statement for 2004 Annual Meeting	Part III

**PHELPS DODGE CORPORATION**  
**Annual Report on Form 10-K**  
For the Year Ended December 31, 2004

Table of Contents	Page
-------------------	------

**PART I.**

<u>Items 1. and 2. Business and Properties</u>	1
<u>Phelps Dodge Mining Company</u>	2
<u>Properties, Facilities and Production</u>	2
<u>U.S. Mines</u>	2
<u>South American Mines</u>	4
<u>Manufacturing Segment</u>	5
<u>Primary Molybdenum Segment</u>	5
<u>Worldwide Copper Production, by Source, Other Metal Production and Sales Data, and Manufacturing and Sales Production</u>	6
<u>Phelps Dodge Copper Production Data, by Source</u>	7
<u>Phelps Dodge Copper Sales Data, by Source</u>	9
<u>Phelps Dodge Other Metal Production and Sales</u>	9
<u>Phelps Dodge Manufacturing and Sales Production</u>	10
<u>Other Mining</u>	11
<u>Ore Reserves</u>	12

Table of Contents	3
-------------------	---

<u>Average Drill-Hole Spacing at Ore Reserve Properties</u>	15
<u>Metallurgical Recovery</u>	15
<u>Mill and Leach Stockpiles</u>	15
<u>Copper and Molybdenum Prices</u>	16
<u>Mineralized Material</u>	17
<u>Sales and Competition</u>	18
<u>Prices, Supply and Consumption</u>	18
<u>Costs</u>	20
<u>Environmental and Other Regulatory Matters</u>	20
<u>Ownership of Property</u>	26
<u>Phelps Dodge Industries</u>	27
<u>Specialty Chemicals Segment</u>	27
<u>Wire and Cable Segment</u>	28
<u>Environmental Matters</u>	29
<u>Labor Matters</u>	30
<u>Research and Development</u>	30
<u>Other Environmental Matters</u>	30
<u>Item 3. Legal Proceedings</u>	32
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	36
<u>Executive Officers of Phelps Dodge Corporation</u>	37

## **PART II.**

<u>Item 5. Market for the Registrant's Common Equity and Related Stockholder Matters</u>	38
<u>Item 6. Selected Financial Data</u>	39
<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	41
<u>Overview of Phelps Dodge Corporation's Businesses and Management's Assessment of Key Factors and Indicators that Could Impact Our Business, Operating Results and Cash Flows</u>	41
<u>Critical Accounting Policies and Estimates</u>	44
<u>Results of Phelps Dodge Mining Company</u>	53
<u>Results of Phelps Dodge Industries</u>	69
<u>Other Matters Relating to the Statement of Consolidated Operations</u>	71
<u>Changes in Financial Condition; Capitalization</u>	74
<u>Capital Outlays</u>	88
<u>Inflation</u>	88
<u>Dividends and Market Price Ranges</u>	88
<u>Quarterly Financial Data</u>	89
<u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	40
<u>Item 8. Financial Statements and Supplementary Data Index to Consolidated Financial Statements</u>	90
<u>Report of Management on Internal Control Over Financial Reporting</u>	90
<u>Report of Independent Registered Public Accounting Firm</u>	91
<u>Statement of Consolidated Operations</u>	92
<u>Consolidated Balance Sheet</u>	93

<u>Consolidated Statement of Cash Flows</u>	94
<u>Consolidated Statement of Shareholders' Equity</u>	95
<u>Notes to Consolidated Financial Statements</u>	96
<u>Financial Data by Geographic Area</u>	135
<u>Financial Data by Business Segment</u>	136
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	N/A
<u>Item 9A. Controls and Procedures</u>	40
<u>Item 9B. Other Information</u>	N/A
<b><u>PART III.</u></b>	
<u>Item 10. Directors and Executive Officers of the Registrant</u>	138
<u>Item 11. Executive Compensation</u>	138
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management</u>	138
<u>Item 13. Certain Relationships and Related Transactions</u>	138
<u>Item 14. Principal Accounting Fees and Services</u>	138
<u>Item 15. Exhibits, Financial Statement Schedules</u>	138
<u>Valuation and Qualifying Accounts and Reserves</u>	142
<u>Signatures</u>	143
<u>EXHIBIT 4.11</u>	
<u>EXHIBIT 10.10</u>	
<u>EXHIBIT 10.14</u>	
<u>EXHIBIT 10.15</u>	
<u>Exhibit 10.16</u>	
<u>EXHIBIT 11</u>	
<u>EXHIBIT 12.1</u>	
<u>EXHIBIT 12.2</u>	
<u>EXHIBIT 21</u>	
<u>EXHIBIT 23</u>	
<u>EXHIBIT 24</u>	
<u>EXHIBIT 31</u>	
<u>EXHIBIT 32</u>	

**Table of Contents**

1

**PHELPS DODGE CORPORATION  
2004 Annual Report on Form 10-K**

**PART I**

**Items 1. and 2. Business and Properties**

Phelps Dodge Corporation (the Company, which also may be referred to as Phelps Dodge, PD, we, us or our) is the world's second largest producer of copper, among the world's largest carbon black and magnet wire producers, and is the world's largest producer of continuous-cast copper rod. We also are one of the world's largest producers/processors of molybdenum and molybdenum products.

The Company consists of two major divisions: (i) Phelps Dodge Mining Company (PDMC) and (ii) Phelps Dodge Industries (PDI).

(i) PDMC includes our worldwide, vertically integrated copper operations from mining through rod production, marketing and sales; molybdenum operations from mining through conversion to chemical and metallurgical products, marketing and sales; other mining operations and investments; and worldwide mineral exploration, technology and project development programs. PDMC includes 12 reportable segments—Morenci, Bagdad, Sierrita, Miami/Bisbee, Chino/Cobre and Tyrone (located in the United States), Candelaria/Ojos del Salado, Cerro Verde and El Abra (located in South America), Manufacturing, Sales and Primary Molybdenum—and other mining activities.

In 2004, PDMC produced 1,260,600 tons of copper on a consolidated basis (1,098,800 tons on a pro rata basis) from worldwide mining operations, and an additional 63,000 tons of copper for our partner's 15 percent undivided interest in the Morenci mine. Gold, silver, molybdenum, rhenium and sulfuric acid are by-products of our copper and molybdenum operations. Production of copper for our own account from our U.S. operations constituted approximately 51 percent of the copper mined in the United States in 2004. Much of our U.S. copper cathode production, together with additional copper cathode purchased from others, is used to produce continuous-cast copper rod, the basic feed for the electrical wire and cable industry. We are also engaged in exploration efforts for metals and minerals throughout the world.

In 2004, PDMC produced 57.5 million pounds of molybdenum from mining operations. High-purity, chemical-grade molybdenum concentrate is produced at our Henderson mine in Colorado. Most of the concentrate produced at Henderson is roasted at our Fort Madison, Iowa, facility and is further processed at the facility's chemical plant into value-added molybdenum chemical products. In addition, some of the concentrate is processed into salable molysulfide for use primarily in the lubricant industry.

Molybdenum concentrate is also produced as a by-product at three of our U.S. copper operations. This concentrate generally is roasted at one of our three roasting operations to produce technical-grade molybdic oxide for sale into the metallurgical markets (i.e., steel industries).

We also have research and process technology facilities primarily at our Process Technology Center in Safford, Arizona; and a research and development facility for engineered materials at our Climax Technology Center near Sahuarita, Arizona.

(ii) PDI is our manufacturing division comprising two reportable segments Specialty Chemicals and Wire and Cable. PDI produces engineered products principally for the global energy, transportation and specialty chemicals sectors.

We produce specialty chemicals at operations in North America, Europe, South America and Asia through Columbian Chemicals Company, one of the world's largest producers of carbon black. Carbon black is a reinforcing agent in natural and synthetic rubber that increases the service lives of tires, hoses, belts and other products for the rubber industry. We also produce specialty carbon black for other industrial applications such as pigments for printing, coatings, plastics and other non-rubber applications.

Our Wire and Cable segment has operations in the United States, Latin America, Asia and Africa. This segment produces magnet wire, copper and aluminum energy cables, specialty conductors and other products for sale principally to original equipment manufacturers for use in electrical motors, generators, transformers, medical applications and public utilities.

The Company is exploring strategic alternatives for PDI that may include potential subsidiary sales, selective asset sales, restructurings, joint ventures and mergers, or, alternatively, retention and selective growth.

Note 22 to our Consolidated Financial Statements contained herein includes financial data for each of the last three years relating to our business segments, including data by geographic area.

Phelps Dodge was incorporated as a business corporation under the laws of the state of New York in 1885. Our world headquarters is located in Phoenix, Arizona, and is a leased property. We employed approximately 14,000 people worldwide on February 15, 2005.

Throughout this document, unless otherwise stated, all references to tons are to short tons, and references to ounces are to troy ounces.

**Available Information.** Phelps Dodge files annual, quarterly and current reports, proxy statements and other information with the U.S. Securities and Exchange Commission (the SEC). You may read and copy any document we file at the SEC's Public Reference Room at Room 1024, 450 Fifth Street, NW, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for information on the Public Reference Room. The SEC maintains a Web site that contains annual, quarterly and current reports, proxy statements and other information that issuers (including Phelps Dodge) file electronically with the SEC. The SEC's Web site is <http://www.sec.gov>.

Phelps Dodge's Web site is <http://www.phelpsdodge.com>. Phelps Dodge makes available free of charge through its internet site, via a link to the SEC's Web site at <http://www.sec.gov>, its annual reports on Form 10-K; quarterly reports on Form 10-Q; current reports on Form 8-K; Forms 3, 4 and 5 filed on behalf of directors and executive officers; and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934 as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC.

Phelps Dodge makes available free of charge on <http://www.phelpsdodge.com> its most recent annual report on Form 10-K, its quarterly reports on Form 10-Q for the current fiscal year, its most recent proxy statement and its most recent summary annual report to shareholders, although in some cases these documents are not

**Table of Contents**

available on our site as soon as they are available on the SEC's site. You will need to have on your computer the Adobe Acrobat® Reader software to view some of these documents, which are in PDF format. If you do not have Adobe Acrobat®, a link to Adobe's internet site, from which you can download the software, is provided free of charge. The information on Phelps Dodge's Web site is not incorporated by reference into this report.

**PHELPS DODGE MINING COMPANY**

PDMC has six reportable copper production segments in the United States (Morenci, Bagdad, Sierrita, Miami/Bisbee, Chino/Cobre and Tyrone) and three reportable copper production segments in South America (Candelaria/Ojos del Salado, Cerro Verde and El Abra). These segments include open-pit mining, underground mining, sulfide ore concentrating, leaching, solution extraction and electrowinning. In addition, the Candelaria and Chino/Cobre segments produce gold and silver. The Bagdad, Sierrita and Chino mines also produce molybdenum and rhenium as by-products.

Our Manufacturing segment consists of conversion facilities, including our smelters, refineries and rod mills. The Manufacturing segment processes copper produced at our mining operations and copper purchased from others into copper anode, cathode and rod. In addition, at times it smelts and refines copper and produces copper rod for customers on a toll basis. Toll arrangements require the tolling customer to deliver appropriate copper-bearing material to our facilities, which we then process into a product that is returned to the customer. The customer pays PDMC for processing its material into the specified products.

Our Sales segment functions as an agent to sell copper from our copper production and manufacturing segments. It also purchases and sells any copper not sold by the South American mines to third parties. Copper is sold to others primarily as rod, cathode or concentrate, and as rod to PDI's Wire and Cable segment.

Our Primary Molybdenum segment consists of the Henderson and Climax mines, related conversion facilities and a technology center. This segment is an integrated producer of molybdenum, with mining, roasting and processing facilities producing high-purity, molybdenum-based chemicals, molybdenum metal powder and metallurgical products. In addition, at times it roasts and/or processes material on a toll basis. Toll arrangements require the tolling customer to deliver appropriate molybdenum-bearing material to our facilities, which we then process into a product that is returned to the customer. The customer pays PDMC for processing its material into the specified products.

The technology center works on new product development and product applications. The principal focus is on molybdenum-based products; however, other metal-based products and application opportunities are also explored. In 2004, a new molybdenum metal powder production facility was commissioned at the technology center in Sahuarita, Arizona, with a capacity of about 1 million pounds per year.

Our six reportable U.S. Mines segments, the Manufacturing and Sales segments and Other Mining are discussed herein together, where appropriate, as U.S. Mining Operations.

Our U.S. Mining Operations and our South American Mines are discussed herein together, where appropriate, as our Worldwide Copper Mining Operations.

**Properties, Facilities and Production**



Following is a map indicating the approximate location of PDMC's U.S. copper and molybdenum mines:

## **United States Mines**

### **U.S. Mines**

We produce electrowon copper cathode at leaching and solution extraction/electrowinning (SX/EW) operations near Tyrone and Silver City, New Mexico (Tyrone (partially curtailed) and Chino (partially curtailed) mines), and Morenci, Miami (curtailed since 2002), Bagdad and Green Valley (Sierrita), Arizona mines. We produce copper concentrate from open-pit mines and concentrators located at Bagdad and Green Valley, Arizona (Bagdad and Sierrita mines, respectively) and Silver City, New Mexico (Chino mine).

We are the world's leading producer of copper using the SX/EW process. In 2004, we produced a total of 567,100 tons of copper cathode at our SX/EW facilities in the United States, compared with 569,600 tons in 2003 and 578,700 tons in 2002. SX/EW is a cost-effective process for extracting copper from certain types of ores. SX/EW is a major factor in our continuing efforts to maintain internationally competitive costs. The annual design plating capacity of our electrowon copper plants is 410,000 tons at Morenci, 105,000 tons at Miami, 75,000 tons at Chino, 84,000 tons at Tyrone, 25,000 tons at Sierrita and 32,500 tons at Bagdad, which includes 17,500 tons of capacity associated with its concentrate leach facility.

### **Morenci**

The Morenci complex in southeastern Arizona comprises an open-pit mine, a concentrator, four solution extraction facilities and three electrowinning tankhouses. We operate Morenci and own an 85 percent undivided interest; the remaining 15 percent interest is owned by Sumitomo Metal Mining Arizona, Inc. (Sumitomo), a jointly owned subsidiary of Sumitomo Metal Mining Co., Ltd., and Sumitomo Corporation. Each partner takes in kind its share of Morenci production. Morenci is the largest copper producing operation in North America.

In 2001, the Company completed its \$220 million mine-for-leach project at Morenci. As a result, the Morenci concentrator was placed on care-and-maintenance status. The crushing facility at the Metcalf

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**Table of Contents**

concentrator continues to process approximately 85,000 tons of ore daily for the expanded leach operation. The mine-for-leach facilities increased Morenci's annual electrowon cathode production capacity to 410,000 tons. Under certain favorable economic circumstances or as necessitated by the mine plan, Morenci may produce concentrates from primary sulfide ores.

We are at present a party to litigation that could adversely impact the allocation of available water supplies for the Morenci operation and our other properties in Arizona. (Refer to Item 3, Legal Proceedings, for information concerning the status of these proceedings.)

**Bagdad**

Our wholly owned Bagdad operation in northwestern Arizona mines copper sulfide and oxide ore. The operation consists of an open-pit mine, sulfide ore concentrator producing copper and molybdenum concentrates, and a leaching system with an SX/EW operation producing copper cathode. In January 2002, as a result of the then-current economic environment, Bagdad's mill throughput was curtailed temporarily to approximately one-half capacity. Based upon the rapid increase in copper prices, our view of market fundamentals for copper and molybdenum over the next several years, and our internal concentrate and sulfuric acid balance, Bagdad began increasing production in January 2004 and resumed producing at full capacity in the 2004 second quarter.

In February 2002, we announced that Bagdad would construct a \$40 million copper concentrate leaching demonstration plant designed to recover 35 million pounds of commercial-grade copper cathode from chalcopyrite concentrates annually. The plant was commissioned in the 2003 first quarter and achieved full production in the 2003 second quarter. During nine months of operation (April to December 2003), the plant processed 44,200 tons of concentrate and produced approximately 24.4 million pounds of copper cathode. During 2004, the plant processed 58,000 tons of concentrate and produced 34.9 million pounds of copper cathode. This technology could assist in our long-term cost reduction strategy.

**Sierrita**

We own the Sierrita mine near Green Valley, Arizona. The facility consists of an open-pit mine, sulfide ore concentrator producing copper and molybdenum concentrates, two molybdenum roasters and a rhenium processing facility. Sierrita also uses an oxide and low-grade sulfide ore stockpile leaching system with an SX/EW operation to produce copper cathode. The Sierrita operation leases property adjacent to its mine upon which its electrowinning tankhouse is located. During 2004, the Sierrita operation entered into a new lease for the property upon which its electrowinning tankhouse facility is located. Construction of a new plant capable of producing approximately 40 million pounds of copper sulfate pentahydrate, as an alternative to cathode production, was completed in late 2004.

Sierrita's on-site roasters process molybdenum concentrates produced at Sierrita, Bagdad and Chino, as well as purchased concentrates or concentrates tolled for third parties. The resulting metallurgical grade molybdc oxide and related products are either packaged for shipment to customers worldwide or transported to other Phelps Dodge facilities for further processing.

At year-end 2001, as a result of the then-current economic environment, mill throughput at the Sierrita mine was reduced temporarily to approximately one-half of its capacity. Based upon the rapid increase in copper prices, our view of market fundamentals for copper and molybdenum over the next several years, and our internal concentrate and sulfuric acid balance, Sierrita began increasing production in January 2004 and resumed producing at full capacity

in the 2004 fourth quarter.

### **Miami/Bisbee**

Our wholly owned operations at Miami, Arizona, consist of an open-pit copper mine, an SX/EW operation producing copper cathode, a smelter, an acid plant, an electrolytic refinery and a copper rod plant. The small Bisbee precipitation operation is located in southern Arizona. In January 2002, as a result of the then-current economic environment, the Miami mine and refinery were closed temporarily. In January 2003, as a result of reduced production at our Bagdad and Sierrita mines along with reduced toll concentrate terms, the Miami smelter was partially curtailed. For 2004, 2003 and 2002, Miami's production of 9,800 tons, 17,800 tons and 10,500 tons, respectively, only reflected residual leach production. During 2004, the Miami mine and refinery remained temporarily suspended. However, based upon the rapid increase in copper prices, our view of market fundamentals for copper over the next several years, and our internal concentrate and sulfuric acid balance, the Miami smelter resumed operating at full capacity in the 2004 second quarter.

### **Chino/Cobre**

We operate an open-pit copper mine, concentrator, leaching and SX/EW facility near Silver City, New Mexico, and a smelter in Hurley, New Mexico, that are owned by Chino Mines Company (Chino), a general partnership in which we held a two-thirds interest through December 18, 2003. Heisei Minerals Corporation (Heisei), a subsidiary of Mitsubishi Materials Corporation and Mitsubishi Corporation, owned the remaining one-third interest in Chino. On December 19, 2003, we purchased Heisei's interest in Chino. Prior to December 19, 2003, each partner purchased its proportionate share of Chino's copper production each month. Beginning in late 1998 and extending through the first half of 1999, production was curtailed resulting in a reduction of approximately 35,000 tons of annual copper production. In March 2001, the concentrator was temporarily shut down. In January 2002, the Chino mine and smelter were closed temporarily. As planned, Chino's SX/EW operations continued producing copper through leaching of existing stockpiles. The production from these stockpiles declined steadily during 2002 and 2003. Limited mining for leach material was renewed in April 2003. In September 2003, Chino resumed a full mine-for-leach operation. Based upon the rapid increase in copper prices, our view of market fundamentals for copper over the next several years, and our internal concentrate and sulfuric acid balance, Chino's milling operations increased to approximately 80 percent of capacity in the 2004 third quarter. A small amount of molybdenum concentrate also is produced at Chino.

On December 19, 2003, a wholly owned subsidiary of the Company acquired Heisei's one-third general partnership interest in Chino. In connection with this transaction, Heisei paid on behalf of Chino approximately \$64 million in cash to a trust to provide a portion of the financial assurance for mine closure/close out obligations. That amount represents a one-third share of the then-current estimate by the state of New Mexico of the amount of financial assurance Chino must provide in connection with its current permits. In addition, Heisei

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**Table of Contents**

paid \$50 million to the Company's subsidiary to cover other Heisei obligations. Due to our business expectations and plans, which resulted in significant differences in the assumed operating life of Chino compared with that assumed by Heisei, we recognized an extraordinary gain of \$68.3 million upon completing the transaction.

Cobre Mining Company Inc. (Cobre) is located in southwestern New Mexico adjacent to our Chino operations. The primary assets of Cobre include an open-pit copper mine, a concentrator, and the surrounding 12,000 acres of land, including mineral rights. In 1999, production was suspended, reducing copper production by approximately 35,000 tons per year. In 2004, Cobre resumed limited mining activities, including rehabilitation of haul roads, drilling and blasting to establish new access to mining areas, and cleaning of pit benches. In December 2002, the Company recognized an impairment charge to write down Cobre's assets by \$115.5 million (before and after taxes). We took this action after revising mine plans and assessing recoverability.

**Tyrone**

Phelps Dodge operates its wholly owned Tyrone open-pit mine and SX/EW plant near Tyrone, New Mexico. Tyrone has been a mine-for-leach operation since 1992. We partially curtailed production at Tyrone in September 2003.

The recommencement of our curtailed mines, and the one-third share of Chino acquired in December 2003, net of other reductions, increased our 2004 copper production by approximately 64 million pounds (on a consolidated basis) compared with 2003 production. We expect to increase our copper production by approximately 164 million pounds (on a consolidated basis) in 2005 compared with 2004 production. This would bring our pro rata share of copper production in 2005 to approximately 2.3 billion pounds (2.7 billion pounds on a consolidated basis).

As a result of increased production at Sierrita, Bagdad and Chino, our 2005 molybdenum by-product production is expected to increase by approximately 3 million pounds compared with 2004 production to a total of 33 million pounds.

Even though we remain optimistic about the copper upturn, we will remain disciplined about our production profile. We will continue to configure our operations so that we can quickly respond to both positive and negative market demand and price swings.

Following is a map indicating the approximate location of PDMC's South American mines:

**South American Mines**

**South American Mines**

We produce electrowon copper cathode at leaching and SX/EW operations near Arequipa, Peru, and near Calama, Chile. We produce copper concentrate from an open-pit and two underground mines and concentrators located near Copiapó, Chile.

In 2004, we produced a total of 337,900 tons of copper cathode at our SX/EW facilities in South America, compared with 346,100 tons in 2003 and 343,500 tons in 2002. Our total annual design capacity of electrowon copper cathode production is 248,000 tons at El Abra and 96,000 tons at Cerro Verde.

### **Candelaria/Ojos del Salado**

We operate the Candelaria mine located near Copiapó in the Atacama Desert of northern Chile. The operation consists of an open-pit and underground copper mine, a concentrator, port and associated facilities. We own an 80 percent partnership interest in Candelaria, a Chilean contractual mining company, through Phelps Dodge Candelaria, Inc., a wholly owned subsidiary. Sumitomo Metal Mining Co., Ltd. and Sumitomo Corporation own the remaining 20 percent interest. In addition, we own two underground mines, a concentrator and associated infrastructure as part of our Ojos del Salado operation. These facilities are owned through our Chilean subsidiary, Compania Contractual Minera Ojos del Salado. In 2004, due to the rapid increase in copper prices, we resumed operation in the concentrator and one of the underground mines. The facilities had been curtailed since 1998. Sumitomo has agreed in principle, subject to the conditions described below, to acquire an equity position in Ojos del Salado of 20 percent.

### **El Abra**

Phelps Dodge owns a 51 percent partnership interest in Sociedad Contractual Minera El Abra (El Abra), a Chilean contractual mining company. El Abra holds mining concessions over more than 33,000 acres of land near Calama in the copper-rich Second Region of northern Chile. The remaining 49 percent is owned by the state-owned copper enterprise Corporación Nacional del Cobre de Chile (CODELCO). The El Abra operation consists of a mine-for-leach, open-pit mining operation that uses three stages of crushing prior to leaching, an on/off heap leach pad, and an SX/EW operation to produce copper cathode. In 2001, El Abra completed a project to leach uncrushed, run-of-mine (ROM) material. The ROM project allows El Abra to better utilize its electrowon facilities. ROM production began in January 2002 with full production from the project achieved in the second half of 2002.

### **Cerro Verde**

We own approximately 82.5 percent of the common stock of Sociedad Minera Cerro Verde S.A.A. (Cerro Verde). Compañía de Minas Buenaventura S.A. (Buenaventura), a publicly traded Peruvian mining concern, owns approximately 9.2 percent of the outstanding shares, and the remainder is publicly traded on the Lima Stock Exchange. The Cerro Verde operation, located approximately 30 kilometers southwest of Arequipa, Peru, consists of two open pits, Cerro Verde and Santa Rosa, a heap-leach operation and an SX/EW operation to produce copper cathode. The ore is processed through three stages of crushing and placed on a leach pad after agglomeration.

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**Table of Contents**

On October 11, 2004, the Phelps Dodge board of directors announced conditional approval for an \$850 million expansion of the Cerro Verde mine. Final approval was contingent upon receiving all required permits from the Peruvian government and placing necessary financing. The required permits and approvals were obtained in the 2004 fourth quarter. In early February 2005, the board approved moving forward on financing and project development. We expect to finalize financing during 2005.

Buenaventura has agreed in principle to increase its ownership in Cerro Verde up to a maximum of 20 percent. In addition, Sumitomo Metal Mining Co. Ltd. and Sumitomo Corporation have agreed in principle to acquire jointly an equity position in Cerro Verde of 21 to 25 percent. The Buenaventura and Sumitomo transactions are subject to a variety of conditions, including the approval of their respective boards of directors, the approval of Cerro Verde's shareholders, and the negotiation and execution of definitive agreements. Phelps Dodge will retain a majority interest in the operation.

The expansion permits the mining of a primary sulfide ore body beneath the leachable ore body currently in production. Through the expansion, approximately 1.4 billion tons of sulfide ore reserves averaging 0.49 percent copper and 0.02 percent molybdenum will be processed through a new concentrator. Processing of the sulfide ore body is expected to begin in late 2006. The current copper production at Cerro Verde is approximately 100,000 tons per year. After the expansion, copper production initially will approximate 300,000 tons per year.

**Manufacturing Segment**

We own and operate copper smelters in Miami, Arizona, and, through Chino Mines Company (in which we held a two-thirds partnership interest through December 18, 2003, and a 100 percent interest effective December 19, 2003), the Chino smelter in Hurley, New Mexico. In January 2002, the Chino smelter was temporarily closed. We smelt virtually all of our share of our U.S. copper concentrate production and, depending on market circumstances and internal production requirements, concentrate production from our South American operations. In addition, we may purchase concentrate to keep our smelters operating at efficient levels.

In September 1999, we suspended operations at our Hidalgo smelter in Hidalgo County, New Mexico, due to a general lack of concentrate availability in the United States and depressed copper market fundamentals. This suspension was coincident with the closure of Morenci's Metcalf concentrator as previously discussed. As a result of the successful acquisition of Cyprus Amax (in which we acquired the Miami smelter) and the decision to convert Morenci to a mine-for-leach operation, we concluded that Hidalgo would probably not be operated in its historic configuration in the foreseeable future. Accordingly, a \$201.5 million pre-tax write-down of the Hidalgo assets was taken in 1999. However, it was anticipated at the time that Hidalgo may have a future as a producer of sulfuric acid for the Company's leaching operations. As a result of the Company's ability to use acid more efficiently and an updated assessment of PDMC's long-term acid production and consumption balance, the Company determined (i) that Hidalgo probably would not be reconfigured to produce acid as originally anticipated and (ii) the net book value of Hidalgo assets probably would not be recovered. In December 2002, the Company recognized an additional \$12.9 million (before and after taxes) impairment charge to write down Hidalgo's assets to their estimated fair value. At the time of the impairment, it was determined that the power facilities would continue to generate electricity when needed, and the facility would continue to be a backup source of acid if conditions warranted. The Company also recognized a \$7.0 million (before and after taxes) charge for the estimated remaining cost of its closure obligation at Hidalgo. As a result of a sale of a portion of the facility in the 2004 third quarter, the Company wrote down the remaining Hidalgo assets by \$1.1 million to current fair value. The smelter and ancillary buildings currently are expected to be

demolished in 2005-2006.

We refine our share of anode copper production from our smelters at our refineries in El Paso, Texas, and Miami, Arizona. From 2000 to 2004, the El Paso refinery operated significantly below capacity due to the late-1999 closing of the Hidalgo smelter, the conversion of the Morenci operation to a mine-for-leach operation in 2001 and the curtailment of certain production facilities in early 2002. The closure of the Hidalgo smelter resulted not only in a curtailment of operations at our El Paso refinery, but also a reduction of approximately 200 refinery jobs. As a result of production curtailments announced in the 2001 fourth quarter, the Miami refinery was temporarily closed.

Our Miami refinery has an annual production capacity of about 200,000 tons of copper cathode. The El Paso refinery has an annual production capacity of about 450,000 tons of copper cathode. The total combined capacity of about 650,000 tons of electrolytic copper per year is sufficient to refine all the anode copper we produce for our account at our operating smelters, as well as anodes from other customers that we refine on a toll basis.

Our El Paso refinery also produces copper sulfate, nickel sulfate (converted to nickel carbonate production in 2004), copper telluride, and autoclaved slimes material containing gold, silver, platinum and palladium.

We are the world's largest producer of continuous-cast copper rod, the basic feed for the electrical wire and cable industry. Most of our refined copper and additional purchased copper cathode are converted into rod at our continuous-cast copper rod facilities in El Paso, Texas; Norwich, Connecticut; Miami, Arizona; and Chicago, Illinois. Our four plants have a collective annual capacity to convert more than 1.1 million tons of refined copper into rod and other refined copper products.

### **Primary Molybdenum Segment**

See the United States Mines map on page 2 for the location of our molybdenum mines.

Phelps Dodge owns the underground Henderson molybdenum mine near Empire, Colorado. The operation consists of an underground block-cave mine where molybdenite ore is mined and transported to a conventional sulfide concentrator. The concentrator is capable of operating at a rate of 32,000 tons of ore per day, producing molybdenum disulfide concentrate containing up to 58 percent molybdenum. Most of the concentrate is shipped to our Fort Madison, Iowa, roasting and chemical processing facility where high-purity products are made for final sale to customers. A portion of Henderson's production is further refined and sold to customers as molysulfide.

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**Table of Contents**

In May 2000, as a result of an oversupply of molybdenum and continued low prices in the world market, Phelps Dodge announced a plan to curtail molybdenum production by approximately 20 percent and reduce its Henderson workforce by approximately 130 workers. In 2001, 2002 and 2003, the previously announced production curtailment essentially remained in place. In 2004, based on rapidly increasing molybdenum prices and our view of market fundamentals for molybdenum, we increased annual production at Henderson to approximately 28 million pounds. Henderson is currently developing the new 7210 foot production level. This level is expected to be capable of producing up to 40 million pounds annually by mid-2006, concurrent with the depletion of ore at the 7700 foot production level of the mine that has been the principal ore production level since 1991.

Phelps Dodge also owns the Climax molybdenum mine near Leadville, Colorado. The operation consists of both an underground and open-pit mine, and a 16,000-ton-per-day concentrator. The Climax molybdenum mine was placed on care-and-maintenance in 1995 by the predecessor owner. At year-end 2004, as well as at the time of acquisition, we expected to bring Climax into production concurrent with the exhaustion of the Henderson molybdenum mine ore reserves for continued long-term primary molybdenum supply for the chemicals business. Nonetheless, we continue to evaluate short- and mid-term production opportunities for the Climax mine based on market conditions and projections as well as manage the facility in a manner that allows its production to commence in a timely and efficient manner. The property comprises more than 14,000 acres.

Phelps Dodge processes molybdenum concentrates at its conversion plants in the United States and Europe into such products as technical-grade molybdic oxide, ferromolybdenum, pure molybdic oxide, ammonium molybdates, molybdenum metal powders and molysulfide. The Company operates molybdenum roasters at Green Valley, Arizona; Fort Madison, Iowa; and Rotterdam, the Netherlands.

The Fort Madison, Iowa, facility consists of two molybdenum roasters, a sulfuric acid plant, a metallurgical (technical oxide) packaging facility, and a chemical conversion plant, which includes a wet chemicals plant and sublimation equipment. In the chemical plant, molybdic oxide is further refined into various high-purity molybdenum chemicals for a wide range of uses by chemical and catalyst manufacturers. In addition to metallurgical oxide products, the Fort Madison facility produces ammonium dimolybdate, pure molybdic oxide, ammonium heptamolybdate, ammonium octamolybdate, sodium molybdate, sublimed pure molybdic oxide and molysulfide.

The Rotterdam conversion plant consists of a molybdenum roaster, sulfuric acid plant, a metallurgical packaging facility and a chemical conversion plant. The plant produces metallurgical products primarily for third parties. Ammonium dimolybdate and pure molybdic oxide are produced in a wet chemical plant.

We also produce ferromolybdenum and molysulfide for worldwide customers at our conversion plant located in Stowmarket, United Kingdom. The plant is operated both as an internal and external customer tolling facility.

Climax has a technology center located in Sahuarita, Arizona, that is focused on new product development and product applications. In 2004, operation of a new molybdenum metal powder production facility, with a capacity of about one million pounds annually, was commissioned to produce value-added products. In addition, work at the technology center is focused on non-molybdenum-based, value-added engineered products and applications.

**Worldwide Copper Production, by Source, Other Metal Production and Sales Data, and Manufacturing and Sales Production**



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The following tables show our worldwide copper production by source for the years 2000 through 2004; aggregate production and sales data for copper, gold, silver, molybdenum and sulfuric acid from these sources for the same years; annual average copper and molybdenum prices; and production from our smelters and refineries. Major changes in operations during the five-year period included:

restart of Ojos del Salado underground mining and milling operations in the 2004 second quarter;

curtailment of Chino operations beginning in the 1998 fourth quarter, followed by temporary shut-down of the concentrator in March 2001 and temporary closure of the mine and smelter in January 2002, a partial restart of mining for leach material in April 2003 with a full restart of mining for leach materials in September 2003, and an increase in milling operations to 80 percent of capacity in the 2004 third quarter;

partial curtailment at Tyrone beginning in September 2003;

completion of the run-of-mine leach project at El Abra with production commencing January 2002;

temporary closure of the Miami mine and refinery in January 2002;

partial curtailment of Miami's smelter throughput in January 2003, followed by restart at full capacity in the 2004 second quarter;

curtailment of mill throughput at Bagdad to approximately one-half capacity in January 2002, followed by an increase in mill throughput to approximately 80 percent in January 2003, and an increase in production in January 2004, reaching capacity in the 2004 second quarter;

curtailment of mill throughput at Sierrita to approximately one-half capacity in January 2002, followed by an increase in production in January 2004, reaching capacity in the 2004 fourth quarter;

conversion of Morenci operations to mine-for-leach during 1999 and 2000, with completion in the 2001 first quarter;

partial curtailment of Henderson operations beginning in the 2000 second quarter, followed by an increase in production to approximately 28 million pounds by the end of 2004, and;

temporary closure of the Hidalgo smelter facilities in September 1999 with a decision in the 2002 fourth quarter that Hidalgo would be a back-up alternative to supply acid, write down of remaining Hidalgo assets to fair value in the 2004 third quarter with the smelter and ancillary buildings currently expected to be demolished in 2005-2006.

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**Table of Contents**

7

**Phelps Dodge Copper Production Data, by Source**

(thousand tons)

	2004	2003	2002	2001	2000
<b>Material mined (a)</b>					
Morenci	234,491	237,338	248,505	281,474	274,871
Bagdad	61,194	48,935	42,912	63,680	69,101
Sierrita	53,231	35,525	23,066	60,869	75,319
Miami				32,702	46,446
Chino	43,443	12,299	220	59,277	61,519
Tyrone	1,647	16,319	45,515	73,990	113,937
Candelaria	106,585	108,442	109,211	126,509	128,464
Ojos del Salado	836				
Cerro Verde	75,727	72,965	75,982	68,685	61,400
El Abra	83,705	87,682	76,831	82,737	67,786
Total material mined	660,859	619,505	622,242	849,923	898,843
Less 15% undivided interest at Morenci	35,174	35,601	37,276	42,220	41,231
Material mined on a consolidated basis	625,685	583,904	584,966	807,703	857,612
Less minority participants' shares previously accounted for on a pro rata basis:					
Chino (b)		3,785	73	19,758	20,506
Candelaria (c)	21,317	21,688	21,842	25,302	25,693
El Abra (d)	41,015	42,964	37,647	40,541	33,215
Material mined on a pro rata basis	563,353	515,467	525,404	722,102	778,198
<b>Mill ore processed</b>					
Morenci				4,301	26,698
Bagdad	27,157	26,103	19,783	31,667	29,846
Sierrita	34,885	26,654	21,439	38,133	38,319
Chino	4,895			3,109	13,889
Candelaria (e)	27,318	26,407	28,507	27,365	26,165
Ojos del Salado	742				
Total mill ore processed	94,997	79,164	69,729	104,575	134,917
Less 15% undivided interest at Morenci				645	4,004
Mill ore processed on a consolidated basis	94,997	79,164	69,729	103,930	130,913
Less minority participants' shares previously accounted for on a pro rata basis:					
Chino (b)				1,036	4,630
Candelaria (c)	5,464	5,281	5,701	5,473	5,233

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Mill ore processed on a pro rata basis	89,533	73,883	64,028	97,421	121,050
<b>Leach ore placed in stockpiles</b>					
Morenci	224,918	228,940	241,955	258,202	236,696
Bagdad (f)	23,627		328	696	
Sierrita	1,330	375	170	14,347	18,386
Miami				10,208	11,032
Chino (f)	30,799	11,066	198	31,009	12,875
Tyrone (f)	18,185	10,722	34,835	27,513	51,446
Cerro Verde	22,628	21,014	24,096	23,436	17,833
El Abra	71,361	80,604	71,224	75,875	62,042
Total leach ore placed in stockpiles	392,848	352,721	372,806	441,286	410,310
Less 15% undivided interest at Morenci	33,738	34,341	36,293	38,729	35,503
Leach ore placed in stockpiles on a consolidated basis	359,110	318,380	336,513	402,557	374,807
Less minority participants' shares previously accounted for on a pro rata basis:					
Chino (b)		3,376	66	10,336	4,292
El Abra (d)	34,967	39,496	34,900	37,179	30,401
Leach ore placed in stockpiles on a pro rata basis	324,143	275,508	301,547	355,042	340,114

See footnote explanations on page 10.

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**Table of Contents**

8

**Phelps Dodge Copper Production Data, by Source**

(thousand tons)

		6,981,845	6,488,712		
Tax-exempt	1,218,921		1,045,124	3,603,235	3,121,681
Federal funds sold	2,132		40,918	181,523	144,911
Dividends	397,137		353,659	1,171,687	1,052,437
<b>Total interest income</b>	<b>12,003,252</b>		<b>11,264,945</b>	<b>35,438,714</b>	<b>32,872,188</b>
<b>Interest expense:</b>					
Deposits	5,232,913		5,111,121	16,041,795	14,515,383
Other borrowed funds	789,136		497,354	1,804,055	1,097,577
<b>Total interest expense</b>	<b>6,022,049</b>		<b>5,608,475</b>	<b>17,845,850</b>	<b>15,612,960</b>
<b>Net interest income</b>	<b>5,981,203</b>		<b>5,656,470</b>	<b>17,592,864</b>	<b>17,259,228</b>
<b>Provision (credit) for loan losses</b>	<b>(264,131)</b>		<b>45,859</b>	<b>(110,527)</b>	<b>(227,371)</b>
<b>Net interest income after provision (credit) for loan losses</b>	<b>6,245,334</b>		<b>5,610,611</b>	<b>17,703,391</b>	<b>17,486,599</b>
<b>Non-interest income:</b>					
Trust department income	438,383		336,207	1,543,048	1,089,285
Service fees	479,930		474,633	1,383,137	1,379,684
Securities gains, net	537,969		330,827	1,444,047	846,135
Gain on sale of loans held for sale	241,548		173,163	539,652	457,150
Merchant and ATM fees	143,859		127,108	426,144	403,328
Gain on foreclosure of real estate	—		10,734	—	482,203
Other	146,284		118,701	430,943	404,894
<b>Total non-interest income</b>	<b>1,987,973</b>		<b>1,571,373</b>	<b>5,766,971</b>	<b>5,062,679</b>
<b>Non-interest expense:</b>					
Salaries and employee benefits	2,480,547		2,341,368	7,543,814	7,128,646
Data processing	535,527		541,865	1,643,884	1,624,142
Occupancy expenses	344,227		294,113	965,715	891,991
Provision for off-balance sheet commitments	233,000		—	233,000	—
Other operating expenses	711,887		639,067	2,146,260	2,024,029
<b>Total non-interest expense</b>	<b>4,305,188</b>		<b>3,816,413</b>	<b>12,532,673</b>	<b>11,668,808</b>
<b>Income before income taxes</b>	<b>3,928,119</b>		<b>3,365,571</b>	<b>10,937,689</b>	<b>10,880,470</b>

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Income tax expense	989,580	819,999	2,650,706	2,657,713
Net income	\$ 2,938,539	\$ 2,545,572	\$ 8,286,983	\$ 8,222,757
Basic and diluted earnings per share	\$ 0.31	\$ 0.27	\$ 0.88	\$ 0.87
Declared dividends per share	\$ 0.27	\$ 0.26	\$ 0.81	\$ 0.78
Comprehensive Income	\$ 4,091,849	\$ 6,971,733	\$ 6,232,334	\$ 9,771,335

4

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Index

## AMES NATIONAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cashflows  
(unaudited)

	Nine Months Ended September 30,	
	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 8,286,983	\$ 8,222,757
Adjustments to reconcile net income to net cash provided by operating activities:		
Credit for loan losses	(110,527)	(227,371)
Provision for off-balance sheet commitments	233,000	—
Amortization and accretion	(162,610)	133,426
Depreciation	788,951	720,603
Provision for deferred taxes	5,264	151,694
Securities gains, net	(1,444,047)	(846,135)
Gain on foreclosure of real estate	—	(482,203)
Change in assets and liabilities:		
Increase (decrease) in loans held for sale	(228,434)	390,095
Decrease in accrued income receivable	(537,536)	(1,694,553)
Increase in other assets	(136,900)	(222,375)
Increase in accrued expenses and other liabilities	585,657	2,016,384
<b>Net cash provided by operating activities</b>	<b>7,279,801</b>	<b>8,162,322</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of securities available-for-sale	(46,780,067)	(51,901,443)
Proceeds from sale of securities available-for-sale	6,076,548	4,925,519
Proceeds from maturities and calls of securities available-for-sale	52,530,817	31,727,977
Net decrease in interest bearing deposits in financial institutions	882,421	2,652,453
Net decrease in federal funds sold	13,100,000	250,000
Net decrease (increase) in loans	(28,631,293)	15,696,626
Purchase of bank premises and equipment	(1,890,880)	(1,603,606)
<b>Net cash (used in) provided by investing by activities</b>	<b>(4,712,454)</b>	<b>1,747,526</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Decrease in deposits	(29,376,571)	(18,681,500)
Increase in federal funds purchased and securities sold under agreements to repurchase	20,504,318	14,409,801
Increase in other borrowings, net	22,891,419	1,411,764
Dividends paid	(7,541,244)	(7,254,332)
Proceeds from issuance of common stock	98,921	127,013
<b>Net cash provided by (used in) financing activities</b>	<b>6,576,843</b>	<b>(9,987,254)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>9,144,190</b>	<b>(77,406)</b>
<b>CASH AND DUE FROM BANKS</b>		

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Beginning	16,510,082	18,092,139
Ending	\$ 25,654,272	\$ 18,014,733
Cash payments for:		
Interest	\$ 17,688,771	\$ 15,515,486
Income taxes	2,526,719	2,869,358

5

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**Index**

**AMES NATIONAL CORPORATION AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

1. Significant Accounting Policies

The consolidated financial statements for the three and nine month periods ended September 30, 2007 and 2006 are unaudited. In the opinion of the management of Ames National Corporation (the "Company"), these financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary to present fairly these consolidated financial statements. The results of operations for the interim periods are not necessarily indicative of results which may be expected for an entire year. Certain information and footnote disclosures normally included in complete financial statements prepared in accordance with generally accepted accounting principles have been omitted in accordance with the requirements for interim financial statements. The interim financial statements and notes thereto should be read in conjunction with the year-end audited financial statements contained in the Company's 10-K. The consolidated condensed financial statements include the accounts of the Company and its wholly-owned banking subsidiaries (the "Banks"). All significant intercompany balances and transactions have been eliminated in consolidation.

2. Dividends

On August 8, 2007, the Company declared a cash dividend on its common stock, payable on November 15, 2007 to stockholders of record as of November 1, 2007, equal to \$0.27 per share.

3. Earnings Per Share

Earnings per share amounts were calculated using the weighted average shares outstanding during the periods presented. The weighted average outstanding shares for the three months ended September 30, 2007 and 2006 were 9,429,580 and 9,425,013 respectively. The weighted average outstanding shares for the nine months ended September 30, 2007 and 2006 were 9,426,803 and 9,421,522, respectively.

4. Off-Balance Sheet Arrangements

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. No material changes in the Company's off-balance sheet arrangements have occurred since December 31, 2006.

5. Long-term Debt

The Company borrowed funds through selling securities under an agreement to repurchase to a money center bank totaling \$20,000,000 in the third quarter of 2007. The term of the repurchase agreements ranged from two to five years with interest rates ranging from 4.09% to 4.40%.

6. New Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in its tax return. The Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim



periods, disclosure and transition. FIN 48 is effective in fiscal years beginning after December 15, 2006. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption, with the cumulative effect adjustment reported as an adjustment to the opening balance of retained earnings. The Company adopted FIN 48 as of January 1, 2007, and the adoption had no significant impact on the consolidated financial statements.

**Index**

The following are disclosures made pursuant to the initial adoption of FIN 48:

- Accounting policy regarding classification of interest and penalties:

The Company has adopted the policy of classifying interest and penalties as income tax expense.

- Unrecognized tax benefits as of date of adoption:

The Company had no significant unrecognized tax benefits as of January 1, 2007 and, likewise, no significant unrecognized tax benefits that, if recognized, would affect the effective tax rate.

- Total interest and penalties recognized:

The Company had recorded no accrued interest or penalties as of the date of adoption.

- Uncertainty on tax position:

The Company had no positions for which it deemed that it is reasonably possible that the total amounts of the unrecognized tax benefit will significantly increase or decrease within the 12 months of the date of adoption.

- Open tax years:

The tax years that remain subject to examination by major tax jurisdictions currently are:

Federal 2004 - 2006

State of Iowa 2004 - 2006

On February 15, 2007, FASB issued Statement of Financial Accounting Standards No. 159, the Fair Value Option for Financial Assets and Financial Liabilities, a standard that provides companies with an option to report selected financial assets and liabilities at fair value. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. The new statement does not eliminate disclosure requirements included in other accounting standards.

This statement is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided, among other things, that the entity makes that choice in the first 120 days of that fiscal year.

The Company will adopt the standard effective January 1, 2008. The Company has not determined the impact that the standard might have on its consolidated financial statements.

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

**Overview**

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



**Index**

The Company does not engage in any material business activities apart from its ownership of the Banks. Products and services offered by the Banks are for commercial and consumer purposes including loans, deposits and trust services. The Banks also offer investment services through a third-party broker dealer. The Company employs twelve individuals to assist with financial reporting, human resources, audit, compliance, marketing, technology systems and the coordination of management activities, in addition to 185 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 cashflow are: (i) interest and fees earned on loans made by the Banks; (ii) securities gains and dividends on equity investments held by the Company and the Banks; (iii) service charges on deposit accounts maintained at the Banks; (iv) interest on fixed income investments held by the Banks; and (v) fees on trust services provided by those Banks exercising trust powers. The Company’s principal expenses are: (i) interest expense on deposit accounts and other borrowings; (ii) salaries and employee benefits; (iii) data processing costs associated with maintaining the Bank’s loan and deposit functions; and (iv) occupancy expenses for maintaining the Banks’ facilities. The largest component contributing to the Company’s net income is net interest income, which is the difference between interest earned on earning assets (primarily loans and investments) and interest paid on interest bearing liabilities (primarily deposits and other borrowings). One of management’s principal functions is to manage the spread between interest earned on earning assets and interest paid on interest bearing liabilities in an effort to maximize net interest income while maintaining an appropriate level of interest rate risk.

Net income for the third quarter of 2007 was \$2,939,000, or \$0.31 per share, a 15% increase above the \$2,546,000 or \$0.27 per share earned during the same period in 2006. The improvement in earnings can be attributed to higher net interest income which increased \$325,000, as well as increases in trust revenues of \$102,000 and securities gains of \$207,000. Partially offsetting some of the income gains was higher non-interest expense primarily related to First National Bank’s new office in Ankeny, Iowa.

For the nine month period ending September 30, 2007, the Company earned net income of \$8,287,000, or \$0.88 per share, a 1% increase from net income of \$8,223,000, or \$0.87 per share, earned a year ago. Current year earnings were aided by an improving net interest margin which was 3.32% compared to 3.29% for the nine month period ending September 30, 2007 and 2006, respectively. This margin improvement increased net interest income for the current nine month period by \$334,000 compared to the same period 2006. Favorable conditions in the equity markets allowed the Company to realize net security gains that were \$597,000 over the previous year. Trust department income was also up over 2006 by \$454,000.

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

- - 
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- Challenges
  - Key Performance Indicators and Industry Results
  - Income Statement Review
  - Balance Sheet Review

**Index**

- Asset Quality and Credit Risk Management
- Liquidity and Capital Resources
- Forward-Looking Statements and Business Risks

**Challenges**

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

- Short-term interest rates have increased significantly since September of 2004 while longer term rates (10 to 20 years) are relatively unchanged since 2004. This movement in short-term rates has caused the yield curve to be flatter or slightly inverted since June 30, 2006. Banks have historically earned higher levels of net interest income by investing in intermediate and longer term loans and investments at higher yields and paying lower deposit expense rates on shorter maturity deposits. If the yield curve remains flat or inverted for the remainder of 2007, the Company's net interest margin may compress.
- If interest rates rise, maintaining net interest income revenues presents a challenge to the Company in 2007. Increases in interest rates may negatively impact the Company's net interest margin as interest expense increases more quickly than interest income. The Company's earning assets (primarily its loan and investment portfolio) have longer maturities than its interest bearing liabilities (primarily deposits and other borrowings); therefore, in a rising interest rate environment, interest expense will increase more quickly than interest income as the interest bearing liabilities reprice more quickly than earning assets. In response to this challenge, the Banks model quarterly the changes in income that would result from various changes in interest rates. Management believes Bank earning assets have the appropriate maturity and repricing characteristics to optimize earnings and the Banks' interest rate risk positions.
- The Company's market in central Iowa has numerous banks, credit unions, and investment and insurance companies competing for similar business opportunities. This competitive environment will continue to put downward pressure on the Banks' net interest margins and thus affect profitability. Strategic planning efforts at the Company and Banks continue to focus on capitalizing on the Banks' strengths in local markets while working to identify opportunities for improvement to gain competitive advantages.
- A potential challenge to the Company's earnings would be poor performance in the Company's equity portfolio, thereby reducing the historical level of realized security gains. The Company, on an unconsolidated basis, invests capital that may be utilized for future expansion in a portfolio of primarily financial and utility stocks totaling \$22 million as of September 30, 2007. The Company focuses on stocks that have historically paid dividends that may lessen the negative effects of a bear market.
- The sub-prime mortgage market has had a negative impact on the financial services industry during 2007. The Company has minimal direct exposure to subprime or option adjustable rate mortgages in its loan and bond portfolios. The financial stocks held in the Company's equity portfolio present an indirect exposure to the current problems in the mortgage market.

**Index****Key Performance Indicators and Industry Results**

Certain key performance indicators for the Company and the industry are presented in the following chart. The industry figures are compiled by the Federal Deposit Insurance Corporation (FDIC) and are derived from 8,615 commercial banks and savings institutions insured by the FDIC. Management reviews these indicators on a quarterly basis for purposes of comparing the Company's performance from quarter to quarter against the industry as a whole.

## Selected Indicators for the Company and the Industry

	September 30, 2007		June 30, 2007		Years Ended December 31,			
	3 Months Ended	9 Months Ended	3 Months Ended		2006		2005	
	Company	Company	Company	Industry*	Company	Industry	Company	Industry
Return on assets	1.39%	1.31%	1.33%	1.21%	1.34%	1.28%	1.40%	1.28%
Return on equity	10.69%	9.92%	10.09%	11.54%	9.99%	12.34%	10.57%	12.46%
Net interest margin	3.39%	3.32%	3.31%	3.34%	3.29%	3.31%	3.56%	3.49%
Efficiency ratio	54.02%	53.65%	51.68%	56.52%	52.27%	56.79%	49.09%	57.24%
Capital ratio	13.05%	13.19%	13.19%	8.18%	13.38%	8.23%	13.21%	8.25%

\*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 1.39% and 1.25%, respectively, for the three month periods ending September 30, 2007 and 2006. The ratio improved in 2007 from the previous year primarily as the result of improving net interest income, trust revenues, and security gains.

- Return on Equity

This ratio is calculated by dividing net income by average equity. It is used to measure the net income or return the Company generated for the shareholders' equity investment in the Company. The Company's annualized return on equity ratio is below that of the industry primarily as a result of the higher level of capital the Company maintains for future growth and acquisitions. The Company's return on average equity was 10.69% and 9.36%, respectively for the three month periods ending September 30, 2007 and 2006.

Index

- Net Interest Margin

The net interest margin for the three months ended September 30, 2007 was 3.39% compared to 3.25% for the three months ended September 30, 2006. The ratio is calculated by dividing net interest income by average earning assets. Earning assets are primarily made up of loans and investments that earn interest. This ratio is used to measure how well the Company is able to maintain interest rates on earning assets above those of interest-bearing liabilities, which is the interest expense paid on deposits and other borrowings. The Company's net interest margin improved when compared to September 30, 2006 and is in line with the industry average for 2007.

- Efficiency Ratio

This ratio is calculated by dividing noninterest expense by net interest income and noninterest income. The ratio is a measure of the Company's ability to manage noninterest expenses. The Company's efficiency ratio compares favorably to the industry's average and was 54.02% and 52.80% for the three months ended September 30, 2007 and 2006, respectively.

- Capital Ratio

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

Industry Results

The FDIC Quarterly Banking Profile reported the following results for the second quarter of 2007:

Industry earnings remained strong in the second quarter of 2007, despite an operating environment that was decidedly less favorable than in earlier quarters. A flat yield curve, rising levels of troubled loans, and a weak housing market all made the task of improving earnings more difficult. Insured commercial banks and savings institutions reported \$36.7 billion in net income for the quarter, a decline of \$1.3 billion (3.4%) from the second quarter of 2006, but \$772 million (2.1%) more than they earned in the first quarter of 2007. The decline in earnings compared to a year ago was caused by higher provisions for loan losses, particularly at larger institutions, and by increased noninterest expenses. The impact of these higher costs was partly offset by increased noninterest income and net interest income. For the second consecutive quarter, fewer than half of all insured institutions reported higher quarterly earnings than a year earlier. The average return on assets (ROA) for the second quarter was 1.21%, down from 1.34% in the second quarter of 2006. More than half of all institutions (59%) reported lower ROAs than a year earlier. There were 824 institutions reporting net losses for the quarter, compared to 600 unprofitable institutions a year earlier. This is the largest year-over-year increase in unprofitable institutions since the third quarter of 1996. The increase in unprofitable institutions was greatest among institutions with less than \$1 billion in assets, and among institutions with high levels of residential real estate and commercial loan exposures. The proportion of unprofitable institutions, (9.6%) of all insured institutions, was the highest level for a second quarter since 1991. More than half of the unprofitable institutions (52.2%) were less than five years old.

Insured institutions added \$11.4 billion in provisions for loan losses to their reserves during the second quarter, the largest quarterly loss provision for the industry since the fourth quarter of 2002. This was \$4.9 billion (75.3%) more than they set aside in the second quarter of 2006. At institutions with assets greater than \$1 billion, loss provisions absorbed 7.7% of net operating revenue (net interest income plus total noninterest income); a year earlier, provisions siphoned off only 4.5% of revenue. Noninterest expenses were \$5.6 billion (6.6%) higher than a year earlier. Spending

for salaries and other employee benefits was up by \$3.5 billion (9.1%). The greatest positive contribution to earnings came from noninterest income, which grew by \$5.6 billion (9.0%). The improvement in noninterest income was led by higher trading revenue (up \$1.4 billion, or 28.5%), increased servicing income (up \$1.1 billion, or 25.1%), and increased fiduciary income (up \$1.0 billion, or 15.8%, at institutions filing Call Reports).



**Index**

**Income Statement Review**

The following highlights a comparative discussion of the major components of net income and their impact for the three month periods ended September 30, 2007 and 2006:

**Critical Accounting Policies**

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

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

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

**Index****AVERAGE BALANCES AND INTEREST RATES**

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

**AVERAGE BALANCE SHEETS AND INTEREST RATES**

Three Months Ended September 30,

ASSETS (dollars in thousands)	Average balance	2007 Revenue/ expense	Yield/ rate	Average balance	2006 Revenue/ expense	Yield/ rate
Interest-earning assets						
Loans (1)						
Commercial	\$ 79,248	\$ 1,584	8.00%	\$ 70,593	\$ 1,427	8.09%
Agricultural	31,873	688	8.63%	33,813	727	8.60%
Real estate	325,532	5,414	6.65%	305,662	4,979	6.52%
Installment and other	21,973	376	6.84%	23,846	372	6.24%
Total loans (including fees)	\$ 458,626	\$ 8,062	7.03%	\$ 433,914	\$ 7,505	6.92%
Investment securities						
Taxable	\$ 202,803	\$ 2,458	4.85%	\$ 218,684	\$ 2,409	4.41%
Tax-exempt (2)	138,165	2,266	6.56%	121,696	1,962	6.45%
Total investment securities	\$ 340,968	\$ 4,724	5.54%	\$ 340,380	\$ 4,371	5.14%
Interest bearing						
deposits with banks	\$ 767	\$ 8	4.17%	\$ 3,921	\$ 35	3.57%
Federal funds sold	56	2	14.29%	2,853	41	5.75%
Total interest-earning assets	\$ 800,417	\$ 12,796	6.39%	\$ 781,068	\$ 11,952	6.12%
Non-interest-earning assets						
	42,516			35,605		
TOTAL ASSETS	\$ 842,933			\$ 816,673		

1 Average loan balances include 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%.



**Index**

## AVERAGE BALANCE SHEETS AND INTEREST RATES

Three Months Ended September 30,

LIABILITIES AND STOCKHOLDERS' EQUITY (dollars in thousands)	2007			2006		
	Average balance	Revenue/ expense	Yield/ rate	Average balance	Revenue/ expense	Yield/ rate
Interest-bearing liabilities						
Deposits						
Savings, NOW accounts, and money markets	\$ 290,779	\$ 1,762	2.42%	\$ 307,788	\$ 2,165	2.81%
Time deposits < \$100,000	178,839	2,037	4.56%	182,885	1,837	4.02%
Time deposits > \$100,000	114,533	1,434	5.01%	95,887	1,109	4.63%
Total deposits	\$ 584,151	\$ 5,233	3.58%	\$ 586,560	\$ 5,111	3.49%
Other borrowed funds	67,904	789	4.65%	42,953	498	4.64%
Total interest-bearing liabilities	\$ 652,055	\$ 6,022	3.69%	\$ 629,513	\$ 5,609	3.56%
Non-interest-bearing liabilities						
Demand deposits	\$ 73,338			\$ 71,010		
Other liabilities	7,539			7,345		
Stockholders' equity	\$ 110,001			\$ 108,805		
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 842,933</b>			<b>\$ 816,673</b>		
Net interest: income / margin		\$ 6,774	3.39%		\$ 6,343	3.25%
Spread Analysis						
Interest income/average assets	\$ 12,796	6.07%		\$ 11,952	5.85%	
Interest expense/average assets	6,022	2.86%		5,609	2.75%	
Net interest income/average assets	6,774	3.21%		6,343	3.11%	



**Index**

**Net Interest Income**

For the three months ended September 30, 2007 and 2006, the Company's net interest margin adjusted for tax exempt income was 3.39% and 3.25%, respectively. Net interest income, prior to the adjustment for tax-exempt income, for the three months ended September 30, 2007 and September 30, 2006 totaled \$5,981,000 and \$5,656,000, respectively.

For the quarter ended September 30, 2007, net interest income increased \$325,000 or 6% when compared to the same period in 2006. Interest income increased \$738,000 or 7% over that same time frame. The increase in interest income was primarily attributable to improved loan and investment yields and volume.

Interest expense increased \$414,000 or 7% for the quarter ended September 30, 2007 when compared to the same period in 2006. The higher interest expense for the quarter is primarily attributable to a higher volume and rate on interest bearing liabilities as market interest rates increased from one year ago.

**Provision for Loan Losses**

The Company's credit for loan losses for the three months ended September 30, 2007 was \$264,000 compared to a provision of \$46,000 during the same period last year.

**Non-interest Income and Expense**

Non-interest income for this quarter increased \$417,000, or 27%, as the result of higher trust department income and increased net securities gains on the Company's investment portfolio.

Non-interest expense was 13% higher in the third quarter of 2007 as the result of a \$233,000 provision expense to increase the reserve for off balance sheet liabilities and the initial costs of employee salaries and benefits associated with the opening of First National Bank's Ankeny office. No losses have occurred during the quarter relating to off balance sheet liabilities. The efficiency ratio for the three months ended September 30, 2007 and 2006 was 54.02% and 52.80%, respectively.

**Income Taxes**

The provision for income taxes for September 30, 2007 and September 30, 2006 was \$990,000 and \$820,000, respectively. This amount represents an effective tax rate of 25% for the three months ended September 30, 2007 versus 24% for the same quarter in 2006. The Company's marginal federal tax rate is currently 35%. The difference between the Company's effective and marginal tax rate is primarily related to investments made in tax exempt securities.

**Index****Income Statement Review for Nine Months Ended September 30, 2007**

The following highlights a comparative discussion of the major components of net income and their impact for the nine months ended September 30, 2007 and 2006:

**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.

**ASSETS**

(dollars in thousands)

**AVERAGE BALANCE SHEETS AND INTEREST RATES**

	Nine Months Ended September 30,					
	Average balance	2007 Revenue/ expense	Yield/ rate	Average balance	2006 Revenue/ expense	Yield/ rate
<b>Loans (1)</b>						
Commercial	\$ 77,569	\$ 4,643	7.98%	\$ 70,619	\$ 4,031	7.61%
Agricultural	32,079	2,047	8.51%	33,345	2,058	8.23%
Real estate	317,712	15,676	6.58%	307,917	14,661	6.35%
Installment and other	22,746	1,134	6.65%	28,719	1,314	6.10%
Total loans (including fees)	\$ 450,106	\$ 23,500	6.96%	\$ 440,600	\$ 22,064	6.68%
<b>Investment securities</b>						
Taxable	\$ 208,004	\$ 7,365	4.72%	\$ 211,711	\$ 6,750	4.25%
Tax-exempt (2)	136,721	6,706	6.54%	122,100	5,853	6.39%
Total investment securities	\$ 344,725	\$ 14,071	8.16%	\$ 333,811	\$ 12,603	5.03%
<b>Interest bearing</b>						
deposits with banks	\$ 942	\$ 33	4.67%	\$ 4,534	\$ 108	3.18%
Federal funds sold	4,762	182	5.10%	3,672	145	5.27%
Total interest-earning assets	\$ 800,535	\$ 37,786	6.29%	\$ 782,617	\$ 34,920	5.95%
<b>Total noninterest-earning assets</b>						
	\$ 44,071			\$ 33,738		
<b>TOTAL ASSETS</b>	<b>\$ 844,606</b>			<b>\$ 816,355</b>		

1 Average loan balance include 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%.

16

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**Index**
**LIABILITIES AND  
STOCKHOLDERS'  
EQUITY**  
(dollars in thousands)

**AVERAGE BALANCE SHEETS AND INTEREST RATES**

	Nine Months Ended September 30,					
	Average balance	2007 Revenue/ expense	Yield/ rate	Average balance	2006 Revenue/ expense	Yield/ rate
<b>Interest-bearing liabilities</b>						
<b>Deposits</b>						
Savings, NOW accounts, and money markets	\$ 311,610	\$ 6,078	2.60%	\$ 316,359	\$ 6,144	2.59%
Time deposits < \$100,000	180,233	5,967	4.41%	181,984	5,158	3.78%
Time deposits > \$100,000	107,932	3,997	4.94%	98,794	3,214	4.34%
Total deposits	\$ 599,775	\$ 16,042	3.57%	\$ 597,137	\$ 14,516	3.24%
Other borrowed funds	53,214	1,804	4.52%	34,911	1,097	4.19%
Total interest-bearing liabilities	\$ 652,989	\$ 17,846	3.64%	\$ 632,048	\$ 15,613	3.29%
<b>Noninterest-bearing liabilities</b>						
Demand deposits	\$ 72,417			\$ 69,520		
Other liabilities	7,814			6,027		
Stockholders' equity	\$ 111,386			\$ 108,760		
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
	\$ 844,606			\$ 816,355		
<b>Net interest income / margin</b>						
		\$ 19,940	3.32%		\$ 19,307	3.29%
<b>Spread Analysis</b>						
Interest income/average assets		\$ 37,786	5.97%		\$ 34,920	5.70%
Interest expense/average assets		17,846	2.82%		15,613	2.55%
Net interest income/average assets		19,940	3.15%		19,307	3.15%



## **Index**

### Net Interest Income

For the nine months ended September 30, 2007 and 2006, the Company's net interest margin adjusted for tax exempt income was 3.32% and 3.29%, respectively. Net interest income, prior to the adjustment for tax-exempt income, for the nine months ended September 30, 2007 compared to the same period in 2006 was \$334,000 higher and totaled \$17,593,000 and \$17,259,000, respectively.

For the nine months ended September 30, 2007, interest income increased \$2,567,000 or 8% when compared to the same period in 2006. The increase was primarily attributable to higher loan and investment yields and volumes than the nine months ended September 30, 2006.

Interest expense increased \$2,233,000 or 14% for the nine months ended September 30, 2007 when compared to the same period in 2006. The higher interest expense for the period is attributable to a higher average rates and increased volumes of deposits and other borrowings as short term market interest rates have increased in comparison to the same period in 2006.

### Provision for Loan Losses

The Company's recorded a credit for loan losses for the first three quarters of this year of \$111,000 compared to a credit of \$227,000 for the nine months ended September 30, 2006. Net loan recoveries of \$242,000 were realized in the nine months ended September 30, 2007 and compare to net charge-offs of \$35,000 for the nine months ended September 30, 2006.

### Non-interest Income and Expense

Non-interest income increased \$704,000, or 14% during the nine months ended September 30, 2007 compared to the same period in 2006 as the result of higher trust department income and increased net securities gains on the Company's investment portfolio. Trust revenues had a one-time increase of approximately \$275,000 in the second quarter of 2007.

Non-interest expense increased \$864,000 or 7% for the first nine months of 2007 compared to the same period in 2006 primarily as the result of the initial costs of employee salaries and benefits associated with the opening of First National Bank's Ankeny office and the provision of \$233,000 to provide additional reserves for off balance sheet commitments, primarily unfunded lines of credit on loans. No losses have occurred in 2007 relating to off balance sheet liabilities.

### Income Taxes

The provision for income taxes for the nine months ended September 30, 2007 and 2006 was \$2,651,000 and \$2,658,000, respectively. These amounts represent an effective tax rate of 24% for both periods. The Company's marginal federal tax rate is currently 35%. The difference between the Company's effective and marginal tax rate is primarily related to investments made in tax exempt securities.

### **Balance Sheet Review**

As of September 30, 2007, total assets were \$851,293,000, a \$12,440,000 increase compared to December 31, 2006. The most significant balance sheet changes since December 31, 2006 were investments and federal funds sold being reinvested in the loan portfolio.



**Index**

Investment Portfolio

The investment portfolio totaled \$341,090,000 as of September 30, 2007, 4% lower than the December 31, 2006 balance of \$354,572,000.

Loan Portfolio

Loan volume grew \$28,741,000, or 7%, during the first nine months as net loans totaled \$457,864,000 as of September 30, 2007 compared to \$429,123,000 as of December 31, 2006. Loan growth was primarily in the commercial and commercial real estate portfolios.

Deposits

Deposits totaled \$650,980,000 as of September 30, 2007, a 4% decrease totaling \$29,377,000 from December 31, 2006. Demand, interest checking (NOW), and savings and money market balances were down 8% to 9% from year end. Deposit balances were down 1% from September 30, 2006.

Other Borrowed Funds

Other borrowed funds as of September 30, 2007 totaled \$81,594,000 compared to the December 31, 2006 total of \$38,198,000. This increase was primarily the result of additional federal funds purchased and repurchase agreements reflected in long-term borrowings with maturities ranging from two through five years.

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, 2006.

**Asset Quality Review and Credit Risk Management**

The Company's credit risk is centered in the loan portfolio, which on September 30, 2007 totaled \$457,864,000 compared to \$429,123,000 as of December 31, 2006. Net loans comprise 54% of total assets as of September 30, 2007. 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 impaired loans consisting of non-accrual loans and loans past due 90 days or more as a percentage of total loans of 0.35% is below that of the Company's peer group of 416 bank holding companies with assets of \$500 million to \$1 billion as of June 30, 2007 of 0.72%.

Impaired loans totaled \$2,982,000 as of September 30, 2007 compared to \$1,049,000 as of December 31, 2006. 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 payments of principal or interest when due according to the contractual terms of the loan agreement. Impaired loans generally include loans accounted for on a non-accrual basis, accruing loans which are contractually past due 90 days or more as to principal or interest payments, and any restructured loans. As of September 30, 2007, non-accrual loans totaled \$2,539,000, loans past due 90 days still accruing totaled \$443,000 and there were no restructured loans outstanding. Other real estate owned totaled \$2,846,000 as of September 30, 2007 and \$2,808,000 as of December 31, 2006.

The allowance for loan losses as a percentage of outstanding loans as of September 30, 2007 and December 31, 2006 was 1.33% and 1.50%, respectively. The allowance for loan and lease losses totaled \$6,181,000 and \$6,533,000 as of September 30, 2007 and December 31, 2006, respectively. Net loan charge-offs for the most recent quarter end totaled \$245,000 compared to net charge-offs of loans of \$11,000 for the three month period ended September 30, 2006.

**Index**

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

**Liquidity and Capital Resources**

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

Liquidity is derived primarily from core deposit growth and retention; principal and interest payments on loans; principal and interest payments, sale, maturity and prepayment of investment securities; net cash provided from operations; and access to other funding sources. Other funding sources include federal funds purchased lines, securities sold under agreements to repurchase (repurchase agreements), Federal Home Loan Bank (FHLB) advances and other capital market sources.

As of September 30, 2007, the level of liquidity and capital resources of the Company remain at a satisfactory level and compare favorably to that of other FDIC insured institutions. 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 the Company’s Current Liquidity Sources
  - Review of the 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 on hand, balances due from other banks, federal funds sold and interest-bearing deposits in financial institutions for September 30, 2007 and December 31, 2006 totaled \$26,316,000 and \$31,154,000, respectively. Federal funds sold being used to fund loan growth is the primary reason for the lower liquidity levels as of September 30, 2007.

Other sources of liquidity available to the Banks as of September 30, 2007 include outstanding lines of credit with the Federal Home Loan Bank of Des Moines, Iowa of \$46,840,000 and federal funds borrowing capacity at correspondent banks of \$99,500,000. The Company had federal funds purchased of \$15,900,000, daily repurchase agreements totaling \$39,332,000, other short term borrowing of \$3,362,000, term repurchase agreements totaling \$20,000,000 and FHLB advances of \$3,000,000 as of September 30, 2007.





**Index**

Total investments as of September 30, 2007 were \$341,090,000 compared to \$354,572,000 as of year-end 2006. 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, 2007.

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

Review of Statements of Cash Flows

Operating cash flows for September 30, 2007 and 2006 totaled \$7,280,000 and \$8,162,000, respectively. The primary variance in operating cash flows for the first nine months of 2007 compared to the same period one year ago relates to a lower source of funds as a result of subtracting security gains and the use of cash to fund loans held for sale. The variance in operating cash flows relating accrued income receivable and accrued expenses largely offset each other in comparing the two year operating results.

Net cash used in investing activities through September 30, 2007 was \$4,712,000 compared to a source of funds from investing of \$1,748,000 for nine month period ending September 30, 2006. Additional growth in the loan portfolio was the most significant use of cash for investing in the first nine months of 2007 as investments and federal funds sold were the source of cash utilized to fund the loan growth.

Net cash provided by financing activities for September 30, 2007 totaled \$6,577,000 compared to a use of cash of \$9,987,000 for the nine month period in 2006. A higher level of federal funds purchased and other borrowings were the largest use of financing cash flows for the nine months ended September 30, 2007. A decrease in deposits partially offset by higher federal funds purchased and repurchase agreements was the most significant factor in 2006. As of September 30, 2007, the Company did not have any external debt financing, off balance sheet financing arrangements, or derivative instruments linked to its stock.

Company Only Cash Flows

The Company's liquidity on an unconsolidated basis is heavily dependent upon dividends paid to the Company by the Banks. The Company requires adequate liquidity to pay its expenses and pay stockholder dividends. For the nine months ended September 30, 2007, dividends paid by the Banks to the Company amounted to \$6,633,000 compared to \$6,551,000 for the same period in 2006. In 2006, dividends paid by the Banks to the Company amounted to \$8,734,000 through December 31, 2006 compared to \$8,634,000 for the year ended December 31, 2005. 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 Company has unconsolidated interest bearing deposits and marketable investment securities totaling \$35,529,000 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 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 flows needs as of September 30, 2007 that is a concern to management.

21

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**Index**

Capital Resources

The Company's total stockholders' equity as of September 30, 2007 totaled \$111,618,000 and was 1% lower than the \$112,923,000 recorded as of December 31, 2006. At September 30, 2007 and December 31, 2006, stockholders' equity as a percentage of total assets was 13.11% and 13.46%, respectively. The capital levels of the Company currently exceed applicable regulatory guidelines as of September 30, 2007.

**Forward-Looking Statements and Business Risks**

The discussion in the foregoing Management Discussion and Analysis and elsewhere in this Report contains forward-looking statements about the Company, its business and its prospects. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include use of the words "believe", "expect", "anticipate", "intend", "plan", "estimate" or words of similar meaning, or future or conditional verbs such as "will", "would", "should", "could" or "may". Forward-looking statements, by their nature, are subject to risks and uncertainties. A number of factors, many of which are beyond the Company's control, could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. Such risks and uncertainties with respect to the Company include, but are not limited to, those related to the economic conditions, particularly in the areas in which the Company and the Banks operate, competitive products and pricing, 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 and the availability of and costs associated with sources of liquidity.

These factors may not constitute all factors that could cause actual results to differ materially from those discussed in any forward-looking statement. The Company operates in a continually changing business environment and new facts emerge from time to time. It cannot predict such factors nor can it assess the impact, if any, of such factors on its financial position or its results of operations. Accordingly, forward-looking statements should not be relied upon as a predictor of actual results. The Company disclaims any responsibility to update any forward-looking statement provided in this document.

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 to-date in 2007 changed significantly when compared to 2006.

Item 4. Controls and Procedures

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) as of September 30, 2007. 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 were effective. There have been no significant changes in the Company's disclosure controls or its internal controls over financial reporting, or in other factors that could significantly affect the disclosure controls or the Company's internal controls over financial reporting.



**Index**

Changes in Internal Controls

There was no change in the Company's internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) of the Exchange Act 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.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable

Item 1.a. Risk Factors

No changes

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

Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

(a) 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.

*Index*

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, 2007

By: */s/ Thomas H. Pohlman*

Thomas H. Pohlman, President  
Principal Executive Officer

By: */s/ John P. Nelson*

John P. Nelson, Vice President  
Principal Financial Officer