

GERMAN AMERICAN BANCORP, INC.  
Form 10-Q  
November 07, 2014  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period  
Ended September 30, 2014

Commission File Number 001-15877

German American Bancorp, Inc.  
(Exact name of registrant as specified in its charter)  
Indiana  
(State or other jurisdiction of  
incorporation or organization)

35-1547518  
(I.R.S. Employer  
Identification No.)

711 Main Street, Jasper, Indiana 47546  
(Address of Principal Executive Offices and Zip Code)

Registrant's telephone number, including area code: (812) 482-1314

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company:

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

YES  NO

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

Class	Outstanding at November 1, 2014
Common Shares, no par value	13,210,395

CAUTION REGARDING FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS

Information included in or incorporated by reference in this Quarterly Report on Form 10-Q, our other filings with the Securities and Exchange Commission (the “SEC”) and our press releases or other public statements, contains or may contain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Please refer to the discussions of our forward-looking statements and associated risks in our annual report on Form 10-K for the year ended December 31, 2013, in Item 1, “Business – Forward-Looking Statements and Associated Risks” and our discussion of risk factors in Item 1A, “Risk Factors” of that annual report on Form 10-K, as updated from time to time in our subsequent SEC filings, including by Item 2 of Part I of this Report (“Management’s Discussion and Analysis of Financial Condition and Results of Operations”) at the conclusion of that Item 2 under the heading “Forward-Looking Statements and Associated Risks.”

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## GERMAN AMERICAN BANCORP, INC.

## CONSOLIDATED BALANCE SHEETS

(unaudited, dollars in thousands except share and per share data)

	September 30, 2014	December 31, 2013
<b>ASSETS</b>		
Cash and Due from Banks	\$37,427	\$37,370
Federal Funds Sold and Other Short-term Investments	49,740	22,762
Cash and Cash Equivalents	87,167	60,132
Interest-bearing Time Deposits with Banks	100	100
Securities Available-for-Sale, at Fair Value	575,741	606,032
Securities Held-to-Maturity, at Cost (Fair value of \$186 and \$271 on September 30, 2014 and December 31, 2013, respectively)	184	268
Loans Held-for-Sale, at Fair Value	7,590	9,265
Loans	1,436,774	1,385,212
Less: Unearned Income	(4,025)	(2,830)
Allowance for Loan Losses	(15,592)	(14,584)
Loans, Net	1,417,157	1,367,798
Stock in FHLB of Indianapolis and Other Restricted Stock, at Cost	9,096	9,004
Premises, Furniture and Equipment, Net	40,322	40,430
Other Real Estate	521	1,029
Goodwill	20,535	20,536
Intangible Assets	2,353	3,328
Company Owned Life Insurance	31,809	31,178
Accrued Interest Receivable and Other Assets	13,346	14,727
<b>TOTAL ASSETS</b>	<b>\$2,205,921</b>	<b>\$2,163,827</b>
<b>LIABILITIES</b>		
Non-interest-bearing Demand Deposits	\$410,329	\$400,024
Interest-bearing Demand, Savings, and Money Market Accounts	1,020,504	1,063,098
Time Deposits	333,638	349,034
Total Deposits	1,764,471	1,812,156
FHLB Advances and Other Borrowings	208,086	140,770
Accrued Interest Payable and Other Liabilities	13,099	10,804
<b>TOTAL LIABILITIES</b>	<b>1,985,656</b>	<b>1,963,730</b>
<b>SHAREHOLDERS' EQUITY</b>		
Preferred Stock, no par value; 500,000 shares authorized, no shares issued	—	—
Common Stock, no par value, \$1 stated value; 30,000,000 shares authorized	13,210	13,174
Additional Paid-in Capital	108,481	108,022
Retained Earnings	98,528	84,164
Accumulated Other Comprehensive Income (Loss)	46	(5,263)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>220,265</b>	<b>200,097</b>

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$2,205,921	\$2,163,827
End of period shares issued and outstanding	13,210,395	13,173,793

See accompanying notes to consolidated financial statements.

GERMAN AMERICAN BANCORP, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
(unaudited, dollars in thousands except per share data)

	Three Months Ended September 30,	
	2014	2013
<b>INTEREST INCOME</b>		
Interest and Fees on Loans	\$16,680	\$15,307
Interest on Federal Funds Sold and Other Short-term Investments	2	2
Interest and Dividends on Securities:		
Taxable	2,531	2,768
Non-taxable	1,135	735
<b>TOTAL INTEREST INCOME</b>	<b>20,348</b>	<b>18,812</b>
<b>INTEREST EXPENSE</b>		
Interest on Deposits	1,025	1,145
Interest on FHLB Advances and Other Borrowings	532	475
<b>TOTAL INTEREST EXPENSE</b>	<b>1,557</b>	<b>1,620</b>
<b>NET INTEREST INCOME</b>	<b>18,791</b>	<b>17,192</b>
Provision for Loan Losses	—	(400)
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>18,791</b>	<b>17,592</b>
<b>NON-INTEREST INCOME</b>		
Trust and Investment Product Fees	901	802
Service Charges on Deposit Accounts	1,300	1,029
Insurance Revenues	1,739	1,495
Company Owned Life Insurance	210	233
Interchange Fee Income	508	449
Other Operating Income	599	395
Net Gains on Sales of Loans	613	613
Net Gains on Securities	567	428
<b>TOTAL NON-INTEREST INCOME</b>	<b>6,437</b>	<b>5,444</b>
<b>NON-INTEREST EXPENSE</b>		
Salaries and Employee Benefits	7,975	7,515
Occupancy Expense	1,262	1,155
Furniture and Equipment Expense	463	438
FDIC Premiums	277	261
Data Processing Fees	935	717
Professional Fees	516	970
Advertising and Promotion	613	447
Intangible Amortization	302	329
Other Operating Expenses	1,739	1,752
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>14,082</b>	<b>13,584</b>
Income before Income Taxes	11,146	9,452
Income Tax Expense	3,438	2,969
<b>NET INCOME</b>	<b>\$7,708</b>	<b>\$6,483</b>

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Basic Earnings Per Share	\$0.58	\$0.51
Diluted Earnings Per Share	\$0.58	\$0.51
Dividends Per Share	\$0.16	\$0.15

See accompanying notes to consolidated financial statements.

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GERMAN AMERICAN BANCORP, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
(unaudited, dollars in thousands except per share data)

	Nine Months Ended September 30,	
	2014	2013
<b>INTEREST INCOME</b>		
Interest and Fees on Loans	\$48,766	\$45,227
Interest on Federal Funds Sold and Other Short-term Investments	8	25
Interest and Dividends on Securities:		
Taxable	7,944	8,380
Non-taxable	3,136	2,008
<b>TOTAL INTEREST INCOME</b>	<b>59,854</b>	<b>55,640</b>
<b>INTEREST EXPENSE</b>		
Interest on Deposits	3,098	3,533
Interest on FHLB Advances and Other Borrowings	1,448	1,978
<b>TOTAL INTEREST EXPENSE</b>	<b>4,546</b>	<b>5,511</b>
<b>NET INTEREST INCOME</b>	<b>55,308</b>	<b>50,129</b>
Provision for Loan Losses	550	(250)
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>54,758</b>	<b>50,379</b>
<b>NON-INTEREST INCOME</b>		
Trust and Investment Product Fees	2,728	2,433
Service Charges on Deposit Accounts	3,552	3,034
Insurance Revenues	5,777	4,658
Company Owned Life Insurance	603	716
Interchange Fee Income	1,467	1,392
Other Operating Income	1,579	1,547
Net Gains on Sales of Loans	1,475	2,176
Net Gains on Securities	1,039	1,508
<b>TOTAL NON-INTEREST INCOME</b>	<b>18,220</b>	<b>17,464</b>
<b>NON-INTEREST EXPENSE</b>		
Salaries and Employee Benefits	24,285	22,926
Occupancy Expense	3,776	3,359
Furniture and Equipment Expense	1,472	1,379
FDIC Premiums	828	776
Data Processing Fees	2,892	2,054
Professional Fees	1,761	2,156
Advertising and Promotion	1,635	1,453
Intangible Amortization	975	1,044
Other Operating Expenses	5,687	5,160
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>43,311</b>	<b>40,307</b>
Income before Income Taxes	29,667	27,536
Income Tax Expense	8,967	8,712
<b>NET INCOME</b>	<b>\$20,700</b>	<b>\$18,824</b>



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Basic Earnings Per Share	\$1.57	\$1.49
Diluted Earnings Per Share	\$1.57	\$1.48
Dividends Per Share	\$0.48	\$0.45

See accompanying notes to consolidated financial statements.

GERMAN AMERICAN BANCORP, INC.  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (unaudited, dollars in thousands)

	Three Months Ended September 30,	
	2014	2013
NET INCOME	\$7,708	\$6,483
Other Comprehensive Income (Loss):		
Unrealized Gains (Losses) on Securities		
Unrealized Holding Gain (Loss) Arising During the Period	871	(1,687 )
Reclassification Adjustment for Losses (Gains) Included in Net Income	(567 )	(428 )
Tax Effect	(96 )	742 )
Net of Tax	208	(1,373 )
Total Other Comprehensive Income (Loss)	208	(1,373 )
COMPREHENSIVE INCOME	\$7,916	\$5,110

GERMAN AMERICAN BANCORP, INC.  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (unaudited, dollars in thousands)

	Nine Months Ended September 30,	
	2014	2013
NET INCOME	\$20,700	\$18,824
Other Comprehensive Income (Loss):		
Unrealized Gains (Losses) on Securities		
Unrealized Holding Gain (Loss) Arising During the Period	9,251	(18,984 )
Reclassification Adjustment for Losses (Gains) Included in Net Income	(1,039 )	(1,508 )
Tax Effect	(2,903 )	7,229 )
Net of Tax	5,309	(13,263 )
Total Other Comprehensive Income (Loss)	5,309	(13,263 )
COMPREHENSIVE INCOME	\$26,009	\$5,561

See accompanying notes to consolidated financial statements.

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GERMAN AMERICAN BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited, dollars in thousands)

	Nine Months Ended September 30,	
	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income	\$20,700	\$18,824
Adjustments to Reconcile Net Income to Net Cash from Operating Activities:		
Net Amortization on Securities	1,510	2,338
Depreciation and Amortization	3,611	3,308
Loans Originated for Sale	(70,603	) (132,471
Proceeds from Sales of Loans Held-for-Sale	73,696	142,433
Provision for Loan Losses	550	(250
Gain on Sale of Loans, net	(1,475	) (2,176
Gain on Securities, net	(1,039	) (1,508
Loss (Gain) on Sales of Other Real Estate and Repossessed Assets	(46	) 258
Loss (Gain) on Disposition and Impairment of Premises and Equipment	28	(70
Increase in Cash Surrender Value of Company Owned Life Insurance	(631	) (709
Equity Based Compensation	482	247
Change in Assets and Liabilities:		
Interest Receivable and Other Assets	(4,708	) 2,799
Interest Payable and Other Liabilities	2,214	278
Net Cash from Operating Activities	24,289	33,301
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from Maturity of Other Short-term Investments	—	2,690
Proceeds from Maturities, Calls, Redemptions of Securities Available-for-Sale	62,892	114,563
Proceeds from Sales of Securities Available-for-Sale	52,711	119,952
Purchase of Securities Available-for-Sale	(74,247	) (231,085
Proceeds from Maturities of Securities Held-to-Maturity	84	78
Purchase of Federal Home Loan Bank Stock	(92	) —
Purchase of Loans	(1,750	) (744
Proceeds from Sales of Loans	—	3,250
Loans Made to Customers, net of Payments Received	(49,436	) (80,564
Proceeds from Sales of Other Real Estate	1,831	1,479
Property and Equipment Expenditures	(2,492	) (2,296
Proceeds from Sales of Property and Equipment	23	88
Net Cash from Investing Activities	(10,476	) (72,589
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Change in Deposits	(47,658	) 30,120
Change in Short-term Borrowings	66,977	31,258
Advances in Long-term Debt	20,321	50,000
Repayments of Long-term Debt	(20,095	) (50,815
Issuance of Common Stock	50	13
Employee Stock Purchase Plan	(37	) (9
Dividends Paid	(6,336	) (5,695
Net Cash from Financing Activities	13,222	54,872

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Net Change in Cash and Cash Equivalents	27,035	15,584
Cash and Cash Equivalents at Beginning of Year	60,132	49,087
Cash and Cash Equivalents at End of Year	\$87,167	\$64,671
Cash Paid During the Year for		
Interest	\$4,650	\$6,096
Income Taxes	7,192	8,732
Supplemental Non Cash Disclosures		
Loans Transferred to Other Real Estate	\$1,277	\$676
Accounts Receivable Transferred to Securities	(3,323	) (45,803
See accompanying notes to consolidated financial statements.		

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GERMAN AMERICAN BANCORP, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 September 30, 2014  
 (unaudited, dollars in thousands except share and per share data)

NOTE 1 – Basis of Presentation

German American Bancorp, Inc. operates primarily in the banking industry. The accounting and reporting policies of German American Bancorp, Inc. and its subsidiaries conform to U.S. generally accepted accounting principles. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. All adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the periods reported have been included in the accompanying unaudited consolidated financial statements, and all such adjustments are of a normal recurring nature. It is suggested that these consolidated financial statements and notes be read in conjunction with the financial statements and notes thereto in the German American Bancorp, Inc. December 31, 2013 Annual Report on Form 10-K. Certain items included in the prior period financial statements were reclassified to conform to the current presentation. There was no effect on net income or total shareholder's equity.

NOTE 2 – Per Share Data

The computations of Basic Earnings per Share and Diluted Earnings per Share are as follows:

	Three Months Ended September 30,	
	2014	2013
Basic Earnings per Share:		
Net Income	\$7,708	\$6,483
Weighted Average Shares Outstanding	13,210,395	12,666,780
Basic Earnings per Share	\$0.58	\$0.51
Diluted Earnings per Share:		
Net Income	\$7,708	\$6,483
Weighted Average Shares Outstanding	13,210,395	12,666,780
Potentially Dilutive Shares, Net	20,280	24,384
Diluted Weighted Average Shares Outstanding	13,230,675	12,691,164
Diluted Earnings per Share	\$0.58	\$0.51

For the three months ended September 30, 2014 and 2013, there were no anti-dilutive shares.

The computations of Basic Earnings per Share and Diluted Earnings per Share are as follows:

	Nine Months Ended September 30,	
	2014	2013
Basic Earnings per Share:		
Net Income	\$20,700	\$18,824
Weighted Average Shares Outstanding	13,200,025	12,658,403
Basic Earnings per Share	\$1.57	\$1.49
Diluted Earnings per Share:		

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Net Income	\$20,700	\$18,824
Weighted Average Shares Outstanding	13,200,025	12,658,403
Potentially Dilutive Shares, Net	20,975	19,950
Diluted Weighted Average Shares Outstanding	13,221,000	12,678,353
Diluted Earnings per Share	\$1.57	\$1.48

For the nine months ended September 30, 2014 and 2013, there were no anti-dilutive shares.

GERMAN AMERICAN BANCORP, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 September 30, 2014  
 (unaudited, dollars in thousands except share and per share data)

NOTE 3 – Securities

The amortized cost, unrealized gross gains and losses recognized in accumulated other comprehensive income (loss), and fair value of Securities Available-for-Sale at September 30, 2014 and December 31, 2013, were as follows:

Securities Available-for-Sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2014				
U.S. Treasury and Agency Securities	\$20,000	\$—	\$(637)	) \$19,363
Obligations of State and Political Subdivisions	134,763	5,858	(92)	) 140,529
Mortgage-backed Securities - Residential	420,466	2,758	(7,728)	) 415,496
Equity Securities	353	—	—	353
Total	\$575,582	\$8,616	\$(8,457)	) \$575,741
December 31, 2013				
U.S. Treasury and Agency Securities	\$20,000	\$—	\$(1,048)	) \$18,952
Obligations of State and Political Subdivisions	112,008	2,388	(899)	) 113,497
Mortgage-backed Securities - Residential	481,724	3,497	(11,991)	) 473,230
Equity Securities	353	—	—	353
Total	\$614,085	\$5,885	\$(13,938)	) \$606,032

Equity securities that do not have readily determinable fair values are included in the above totals, are carried at historical cost and are evaluated for impairment on a periodic basis. All mortgage-backed securities in the above table are residential mortgage-backed securities and guaranteed by government sponsored entities.

The carrying amount, unrecognized gains and losses and fair value of Securities Held-to-Maturity at September 30, 2014 and December 31, 2013, were as follows:

Securities Held-to-Maturity:	Carrying Amount	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
September 30, 2014				
Obligations of State and Political Subdivisions	\$184	\$2	\$—	\$186
December 31, 2013				
Obligations of State and Political Subdivisions	\$268	\$3	\$—	\$271





GERMAN AMERICAN BANCORP, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 September 30, 2014  
 (unaudited, dollars in thousands except share and per share data)

## NOTE 3 - Securities (continued)

The amortized cost and fair value of Securities at September 30, 2014 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because some issuers have the right to call or prepay certain obligations with or without call or prepayment penalties. Mortgage-backed and Equity Securities are not due at a single maturity date and are shown separately.

Securities Available-for-Sale:	Amortized Cost	Fair Value
Due in one year or less	\$3,716	\$3,737
Due after one year through five years	20,274	20,174
Due after five years through ten years	65,615	67,862
Due after ten years	65,158	68,119
Mortgage-backed Securities - Residential	420,466	415,496
Equity Securities	353	353
Total	\$575,582	\$575,741

Securities Held-to-Maturity:	Carrying Amount	Fair Value
Due in one year or less	\$—	\$—
Due after one year through five years	184	186
Due after five years through ten years	—	—
Due after ten years	—	—
Total	\$184	\$186

Proceeds from the Sales of Securities are summarized below:

	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013
Proceeds from Sales	\$45,473	\$19,231
Gross Gains on Sales	567	428
Income Taxes on Gross Gains	198	150
	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Proceeds from Sales	\$52,711	\$119,952
Gross Gains on Sales	1,039	1,508
Income Taxes on Gross Gains	364	528



GERMAN AMERICAN BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
September 30, 2014  
(unaudited, dollars in thousands except share and per share data)

## NOTE 3 - Securities (continued)

Below is a summary of securities with unrealized losses as of September 30, 2014 and December 31, 2013, presented by length of time the securities have been in a continuous unrealized loss position:

September 30, 2014	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and Agency Securities	\$—	\$—	\$19,363	\$(637)	\$19,363	\$(637)
Obligations of State and Political Subdivisions	4,849	(35)	4,038	(57)	8,887	(92)
Mortgage-backed Securities - Residential	67,038	(543)	239,488	(7,185)	306,526	(7,728)
Equity Securities	—	—	—	—	—	—
Total	\$71,887	\$(578)	\$262,889	\$(7,879)	\$334,776	\$(8,457)

  

December 31, 2013	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and Agency Securities	\$18,952	\$(1,048)	\$—	\$—	\$18,952	\$(1,048)
Obligations of State and Political Subdivisions	38,878	(899)	—	—	38,878	(899)
Mortgage-backed Securities - Residential	346,028	(11,903)	1,735	(88)	347,763	(11,991)
Equity Securities	—	—	—	—	—	—
Total	\$403,858	\$(13,850)	\$1,735	\$(88)	\$405,593	\$(13,938)

Securities are written down to fair value when a decline in fair value is not considered temporary. In estimating other-than-temporary losses, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The Company doesn't intend to sell or expect to be required to sell these securities, and the decline in fair value is largely due to changes in market interest rates, therefore, the Company does not consider these securities to be other-than-temporarily impaired. All mortgage-backed securities in the Company's portfolio are guaranteed by government sponsored entities, are investment grade, and are performing as expected.

## NOTE 4 – Derivatives

The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. The notional amounts of these interest rate swaps and the offsetting counterparty derivative instruments were \$23.2 million at September 30, 2014 and \$17.9 million at December 31, 2013. These interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions with approved, reputable,

independent counterparties with substantially matching terms. The agreements are considered stand alone derivatives and changes in the fair value of derivatives are reported in earnings as non-interest income.

Credit risk arises from the possible inability of counterparties to meet the terms of their contracts. The Company's exposure is limited to the replacement value of the contracts rather than the notional, principal or contract amounts. There are provisions in the agreements with the counterparties that allow for certain unsecured credit exposure up to an agreed threshold. Exposures in excess of the agreed thresholds are collateralized. In addition, the Company minimizes credit risk through credit approvals, limits, and monitoring procedures.

GERMAN AMERICAN BANCORP, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 September 30, 2014  
 (unaudited, dollars in thousands except share and per share data)

## NOTE 4 - Derivatives (continued)

The following table reflects the fair value hedges included in the Consolidated Balance Sheets as of:

	September 30, 2014		December 31, 2013	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Included in Other Assets:				
Interest Rate Swaps	\$23,233	\$470	\$17,853	\$866
Included in Other Liabilities:				
Interest Rate Swaps	\$23,233	\$412	\$17,853	\$737

The following tables present the effect of derivative instruments on the Consolidated Statements of Income for the periods presented:

	Three Months Ended		Nine Months Ended	
	September 30, 2014	2013	September 30, 2014	2013
Interest Rate Swaps:				
Included in Interest Income / (Expense)	\$—	\$—	\$—	\$—
Included in Other Income / (Expense)	(4	) (34	) 74	517

## NOTE 5 – Loans

Loans were comprised of the following classifications at September 30, 2014 and December 31, 2013:

	September 30, 2014	December 31, 2013
Commercial:		
Commercial and Industrial Loans and Leases	\$377,845	\$350,955
Commercial Real Estate Loans	586,012	582,066
Agricultural Loans	201,867	192,880
Retail:		
Home Equity Loans	85,160	81,504
Consumer Loans	48,604	49,124
Residential Mortgage Loans	137,286	128,683
Subtotal	1,436,774	1,385,212
Less: Unearned Income	(4,025	) (2,830
Allowance for Loan Losses	(15,592	) (14,584
Loans, Net	\$1,417,157	\$1,367,798

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## NOTE 5 - Loans (continued)

The following tables present the activity in the allowance for loan losses by portfolio class for the three months ending September 30, 2014 and 2013:

September 30, 2014	Commercial and Industrial Loans and Leases	Commercial Real Estate Loans	Agricultural Loans	Home Equity Loans	Consumer Loans	Residential Mortgage Loans	Unallocated	Total
Beginning Balance	\$5,661	\$7,199	\$1,016	\$418	\$326	\$435	\$495	\$15,550
Provision for Loan Losses	(563 )	206	156	(33 )	77	(33 )	190	—
Recoveries	19	55	—	—	41	6	—	121
Loans Charged-off	—	(6 )	—	(7 )	(65 )	(1 )	—	(79 )
Ending Balance	\$5,117	\$7,454	\$1,172	\$378	\$379	\$407	\$685	\$15,592

September 30, 2013	Commercial and Industrial Loans and Leases	Commercial Real Estate Loans	Agricultural Loans	Home Equity Loans	Consumer Loans	Residential Mortgage Loans	Unallocated	Total
Beginning Balance	\$4,258	\$8,636	\$817	\$313	\$199	\$280	\$760	\$15,263
Provision for Loan Losses	(361 )	(214 )	53	89	64	36	(67 )	(400 )
Recoveries	108	7	—	—	33	2	—	150
Loans Charged-off	(34 )	(212 )	—	(193 )	(93 )	(17 )	—	(549 )
Ending Balance	\$3,971	\$8,217	\$870	\$209	\$203	\$301	\$693	\$14,464

The following tables present the activity in the allowance for loan losses by portfolio class for the nine months ending September 30, 2014 and 2013:

September 30, 2014	Commercial and Industrial Loans and Leases	Commercial Real Estate Loans	Agricultural Loans	Home Equity Loans	Consumer Loans	Residential Mortgage Loans	Unallocated	Total
Beginning Balance	\$3,983	\$8,335	\$946	\$239	\$188	\$281	\$612	\$14,584
Provision for Loan Losses	1,124	(1,546 )	226	148	296	229	73	550
Recoveries	97	785	—	42	127	14	—	1,065
Loans Charged-off	(87 )	(120 )	—	(51 )	(232 )	(117 )	—	(607 )
Ending Balance	\$5,117	\$7,454	\$1,172	\$378	\$379	\$407	\$685	\$15,592

September 30, 2013	Commercial and Industrial Loans and Leases	Commercial Real Estate Loans	Agricultural Loans	Home Equity Loans	Consumer Loans	Residential Mortgage Loans	Unallocated	Total
Beginning Balance	\$4,258	\$8,636	\$817	\$313	\$199	\$280	\$760	\$15,263
Provision for Loan Losses	(361 )	(214 )	53	89	64	36	(67 )	(400 )
Recoveries	108	7	—	—	33	2	—	150
Loans Charged-off	(34 )	(212 )	—	(193 )	(93 )	(17 )	—	(549 )
Ending Balance	\$3,971	\$8,217	\$870	\$209	\$203	\$301	\$693	\$14,464

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Beginning Balance	\$4,555	\$8,931	\$989	\$141	\$214	\$186	\$504	\$15,520
Provision for Loan Losses	(618 )	(261 )	(119 )	326	100	133	189	(250 )
Recoveries	121	85	—	—	104	5	—	315
Loans Charged-off	(87 )	(538 )	—	(258 )	(215 )	(23 )	—	(1,121 )
Ending Balance	\$3,971	\$8,217	\$870	\$209	\$203	\$301	\$693	\$14,464

In determining the adequacy of the allowance for loan loss, general allocations are made for other pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a three-year historical average for loan losses for these portfolios, judgmentally adjusted for current economic factors and portfolio trends.



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NOTE 5 - Loans (continued)

During the third quarter of 2014, a modification was made to the Company's standard methodology for calculating the allowance for loan losses. This modification centered on commercial and agricultural loans that are graded as substandard and was undertaken as a part of the Company's annual update of its migration analysis utilized in the allowance for loan losses calculations. Prior to the third quarter of 2014, the allocation for substandard, non-impaired commercial and agricultural loans was based on evaluating the amount of loss of each individual credit relationship internally graded substandard. Beginning in the third quarter of 2014, the Company adjusted its methodology to assign allocations for substandard commercial and agricultural credits based on migration analysis techniques utilizing three year migration periods for these types of credits. The modification to the methodology during the third quarter of 2014 resulted in a decrease of \$63 to the overall required loan loss allowance.

Loan impairment is reported when full repayment under the terms of the loan is not expected. This methodology is used for all loans, including loans acquired with deteriorated credit quality. For purchased loans, the assessment is made at the time of acquisition as well as over the life of loan. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate, or at the fair value of collateral if repayment is expected solely from the collateral. Commercial and industrial loans, commercial real estate loans, and agricultural loans are evaluated individually for impairment. Smaller balance homogeneous loans are evaluated for impairment in total. Such loans include real estate loans secured by one-to-four family residences and loans to individuals for household, family and other personal expenditures. Individually evaluated loans on non-accrual are generally considered impaired. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio class and based on impairment method as of September 30, 2014 and December 31, 2013:

September 30, 2014	Total	Commercial and Industrial Loans and Leases	Commercial Real Estate Loans	Agricultural Loans	Home Equity Loans	Consumer Loans	Residential Mortgage Loans	Unallocated
Allowance for Loan Losses:								
Ending Allowance Balance								
Attributable to Loans:								
Individually Evaluated for Impairment	\$ 1,579	\$ 205	\$ 1,374	\$ —	\$ —	\$ —	\$ —	\$ —
Collectively Evaluated for Impairment	13,981	4,912	6,075	1,172	378	379	380	685
Acquired with Deteriorated Credit Quality	32	—	5	—	—	—	27	—

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Total Ending Allowance Balance	\$ 15,592	\$ 5,117	\$ 7,454	\$ 1,172	\$ 378	\$ 379	\$ 407	\$ 685
Loans:								
Loans Individually Evaluated for Impairment	\$ 5,951	\$ 2,157	\$ 3,794	\$ —	\$ —	\$ —	\$ —	\$ —
Loans Collectively Evaluated for Impairment	1,428,066	376,176	576,848	204,792	85,474	48,615	136,161	—
Loans Acquired with Deteriorated Credit Quality	8,731	387	6,724	—	—	122	1,498	—
Total Ending Loans Balance <sup>(1)</sup>	\$ 1,442,748	\$ 378,720	\$ 587,366	\$ 204,792	\$ 85,474	\$ 48,737	\$ 137,659	\$ —

<sup>(1)</sup>Total recorded investment in loans includes \$5,974 in accrued interest.

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## NOTE 5 - Loans (continued)

December 31, 2013	Total	Commercial and Industrial Loans and Leases	Commercial Real Estate Loans	Agricultural Loans	Home Equity Loans	Consumer Loans	Residential Mortgage Loans	Unallocated
Allowance for Loan Losses: Ending Allowance Balance Attributable to Loans:								
Individually Evaluated for Impairment	\$3,095	\$45	\$3,050	\$—	\$—	\$—	\$—	\$—
Collectively Evaluated for Impairment	11,481	3,938	5,277	946	239	188	281	612
Acquired with Deteriorated Credit Quality	8	—	8	—	—	—	—	—
Total Ending Allowance Balance	\$14,584	\$3,983	\$8,335	\$946	\$239	\$188	\$281	\$612
Loans:								
Loans Individually Evaluated for Impairment	\$8,458	\$2,114	\$6,344	\$—	\$—	\$—	\$—	\$—
Loans Collectively Evaluated for Impairment	1,367,591	347,808	566,389	195,171	81,812	49,131	127,280	—
Loans Acquired with Deteriorated Credit Quality	14,753	1,981	10,871	—	—	134	1,767	—
Total Ending Loans Balance <sup>(1)</sup>	\$1,390,802	\$351,903	\$583,604	\$195,171	\$81,812	\$49,265	\$129,047	\$—

<sup>(1)</sup>Total recorded investment in loans includes \$5,590 in accrued interest.

The following tables present loans individually evaluated for impairment by class of loans as of September 30, 2014 and December 31, 2013:

September 30, 2014	Unpaid Principal Balance <sup>(1)</sup>	Recorded Investment	Allowance for Loan Losses Allocated
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With No Related Allowance Recorded:			
Commercial and Industrial Loans and Leases	\$1,967	\$1,954	\$—
Commercial Real Estate Loans	2,660	1,537	—
Agricultural Loans	—	—	—
Subtotal	4,627	3,491	—
With An Allowance Recorded:			
Commercial and Industrial Loans and Leases	207	207	205
Commercial Real Estate Loans	2,772	2,618	1,379
Agricultural Loans	—	—	—
Subtotal	2,979	2,825	1,584
Total	\$7,606	\$6,316	\$1,584
Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above)	\$1,109	\$359	\$—
Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above)	\$30	\$5	\$5

(1) Unpaid Principal Balance is the remaining contractual payments without reduction of partial charge-offs.

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NOTE 5 - Loans (continued)

December 31, 2013	Unpaid Principal Balance <sup>(1)</sup>	Recorded Investment	Allowance for Loan Losses Allocated
With No Related Allowance Recorded:			
Commercial and Industrial Loans and Leases	\$2,163	\$2,072	\$—
Commercial Real Estate Loans	4,710	2,383	—
Agricultural Loans	—	—	—
Subtotal	6,873	4,455	—
With An Allowance Recorded:			
Commercial and Industrial Loans and Leases	45	45	45
Commercial Real Estate Loans	4,428	4,417	3,058
Agricultural Loans	—	—	—
Subtotal	4,473	4,462	3,103
Total	\$11,346	\$8,917	\$3,103
Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above)	\$987	\$451	\$—
Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above)	\$33	\$8	\$8

<sup>(1)</sup> Unpaid Principal Balance is the remaining contractual payments without reduction of partial charge-offs.

The following tables present loans individually evaluated for impairment by class of loans for the three month period ended September 30, 2014 and 2013:

September 30, 2014	Average Recorded Investment	Interest Income Recognized	Cash Basis Recognized
With No Related Allowance Recorded:			
Commercial and Industrial Loans and Leases	\$2,005	\$29	\$30
Commercial Real Estate Loans	2,384	18	21
Agricultural Loans	—	—	—
Subtotal	4,389	47	51
With An Allowance Recorded:			
Commercial and Industrial Loans and Leases	211	1	1
Commercial Real Estate Loans	2,643	4	3
Agricultural Loans	—	—	—
Subtotal	2,854	5	4
Total	\$7,243	\$52	\$55
Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above)	\$773	\$—	\$—
Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above)	\$31	\$1	\$1



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## NOTE 5 - Loans (continued)

September 30, 2013	Average Recorded Investment	Interest Income Recognized	Cash Basis Recognized
With No Related Allowance Recorded:			
Commercial and Industrial Loans and Leases	\$2,223	\$33	\$32
Commercial Real Estate Loans	1,956	1	2
Agricultural Loans	751	21	16
Subtotal	4,930	55	50
With An Allowance Recorded:			
Commercial and Industrial Loans and Leases	464	1	1
Commercial Real Estate Loans	5,415	5	4
Agricultural Loans	—	—	—
Subtotal	5,879	6	5
Total	\$10,809	\$61	\$55
Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above)	\$119	\$—	\$—
Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above)	\$214	\$1	\$1

The following tables present loans individually evaluated for impairment by class of loans for the nine month period ended September 30, 2014 and 2013:

September 30, 2014	Average Recorded Investment	Interest Income Recognized	Cash Basis Recognized
With No Related Allowance Recorded:			
Commercial and Industrial Loans and Leases	\$2,106	\$105	\$107
Commercial Real Estate Loans	2,714	73	70
Agricultural Loans	—	—	—
Subtotal	4,820	178	177
With An Allowance Recorded:			
Commercial and Industrial Loans and Leases	1,600	1	1
Commercial Real Estate Loans	3,158	16	13
Agricultural Loans	—	—	—
Subtotal	4,758	17	14
Total	\$9,578	\$195	\$191
Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above)	\$873	\$3	\$3
Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above)	\$32	\$1	\$1





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## NOTE 5 - Loans (continued)

September 30, 2013	Average Recorded Investment	Interest Income Recognized	Cash Basis Recognized
With No Related Allowance Recorded:			
Commercial and Industrial Loans and Leases	\$818	\$33	\$33
Commercial Real Estate Loans	2,196	1	2
Agricultural Loans	1,738	196	200
Subtotal	4,752	230	235
With An Allowance Recorded:			
Commercial and Industrial Loans and Leases	1,797	3	3
Commercial Real Estate Loans	5,745	17	13
Agricultural Loans	—	—	—
Subtotal	7,542	20	16
Total	\$12,294	\$250	\$251
Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above)	\$39	\$—	\$—
Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above)	\$182	\$2	\$2

All classes of loans, including loans acquired with deteriorated credit quality, are generally placed on non-accrual status when scheduled principal or interest payments are past due for 90 days or more or when the borrower's ability to repay becomes doubtful. For purchased loans, the determination is made at the time of acquisition as well as over the life of the loan. Uncollected accrued interest for each class of loans is reversed against income at the time a loan is placed on non-accrual. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. All classes of loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Loans are typically charged-off at 180 days past due, or earlier if deemed uncollectible. Exceptions to the non-accrual and charge-off policies are made when the loan is well secured and in the process of collection.

The following table presents the recorded investment in non-accrual loans and loans past due 90 days or more still on accrual by class of loans as of September 30, 2014 and December 31, 2013:

	Non-Accrual		Loans Past Due 90 Days or More & Still Accruing	
	2014	2013	2014	2013
Commercial and Industrial Loans and Leases	\$279	\$31	\$83	\$—
Commercial Real Estate Loans	3,308	6,658	—	8
Agricultural Loans	—	—	13	—
Home Equity Loans	308	114	—	—
Consumer Loans	190	236	—	—
Residential Mortgage Loans	1,582	1,339	—	—
Total	\$5,667	\$8,378	\$96	\$8
	\$1,164	\$1,705	\$—	\$—

Loans Acquired With Deteriorated Credit Quality  
(Included in the Total Above)

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## NOTE 5 - Loans (continued)

The following table presents the aging of the recorded investment in past due loans by class of loans as of September 30, 2014 and December 31, 2013:

September 30, 2014	Total	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Loans Not Past Due
Commercial and Industrial Loans and Leases	\$378,720	\$265	\$40	\$307	\$612	\$378,108
Commercial Real Estate Loans	587,366	411	—	889	1,300	586,066
Agricultural Loans	204,792	105	74	13	192	204,600
Home Equity Loans	85,474	330	—	308	638	84,836
Consumer Loans	48,737	175	63	66	304	48,433
Residential Mortgage Loans	137,659	1,637	811	1,411	3,859	133,800
Total <sup>(1)</sup>	\$1,442,748	\$2,923	\$988	\$2,994	\$6,905	\$1,435,843
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	\$8,731	\$—	\$—	\$645	\$645	\$8,086

<sup>(1)</sup>Total recorded investment in loans includes \$5,974 in accrued interest.

December 31, 2013	Total	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Loans Not Past Due
Commercial and Industrial Loans and Leases	\$351,903	\$256	\$78	\$—	\$334	\$351,569
Commercial Real Estate Loans	583,604	613	62	2,234	2,909	580,695
Agricultural Loans	195,171	62	—	—	62	195,109
Home Equity Loans	81,812	303	33	114	450	81,362
Consumer Loans	49,265	149	66	102	317	48,948
Residential Mortgage Loans	129,047	2,206	192	1,115	3,513	125,534
Total <sup>(1)</sup>	\$1,390,802	\$3,589	\$431	\$3,565	\$7,585	\$1,383,217
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	\$14,753	\$148	\$—	\$1,103	\$1,251	\$13,502

<sup>(1)</sup>Total recorded investment in loans includes \$5,590 in accrued interest.

## Troubled Debt Restructurings:

In certain instances, the Company may choose to restructure the contractual terms of loans. A troubled debt restructuring occurs when the Bank grants a concession to the borrower that it would not otherwise consider due to a borrower's financial difficulty. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without modification. This evaluation is performed under the Company's internal underwriting

policy. The Company uses the same methodology for loans acquired with deteriorated credit quality as for all other loans when determining whether the loan is a troubled debt restructuring.

During the three months ended September 30, 2014 and 2013, there were no additional loans modified as troubled debt restructurings. There were no troubled debt restructurings for the three months ended September 30, 2014 and the year ended December 31, 2013 for loans acquired with deteriorated credit quality at the time of acquisition.

During the nine months ended September 30, 2014, there was one loan modified as troubled debt restructurings. The modification of the terms of this loan included a permanent reduction of the recorded investment in the loan. During the nine months ended September 30 2013, there was one loan modified as a troubled debt restructuring. There were no troubled debt restructurings for the nine months ended September 30, 2014 and the year ended December 31, 2013 for loans acquired with deteriorated credit quality at the time of acquisition.

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## NOTE 5 - Loans (continued)

The following tables present the recorded investment of troubled debt restructurings by class of loans as of September 30, 2014 and December 31, 2013:

September 30, 2014	Total	Performing	Non-Accrual <sup>(1)</sup>
Commercial and Industrial Loans and Leases	\$1,889	\$1,882	\$7
Commercial Real Estate Loans	2,838	842	1,996
Total	\$4,727	\$2,724	\$2,003

  

December 31, 2013	Total	Performing	Non-Accrual <sup>(1)</sup>
Commercial and Industrial Loans and Leases	\$2,092	\$2,086	\$6
Commercial Real Estate Loans	4,325	364	3,961
Total	\$6,417	\$2,450	\$3,967

<sup>(1)</sup>The non-accrual troubled debt restructurings are included in the Non-Accrual Loan table presented on previous page.

The Company had not committed to lending any additional amounts as of September 30, 2014 to customers with outstanding loans that are classified as troubled debt restructurings. The Company had committed to lending an additional amount of \$40 as of December 31, 2013 to customers with outstanding loans that are classified as troubled debt restructurings.

The following tables present loans by class modified as troubled debt restructurings that occurred during the three months ending September 30, 2014 and 2013:

September 30, 2014	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial and Industrial Loans and Leases	—	\$—	\$—
Commercial Real Estate Loans	—	—	—
Total	—	\$—	\$—

The troubled debt restructurings described above increased the allowance for loan losses by \$0 and resulted in charge-offs of \$0 during the three months ending September 30, 2014.

September 30, 2013	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial and Industrial Loans and Leases	1	\$224	\$230
Commercial Real Estate Loans	—	—	—
Total	1	\$224	\$230

The troubled debt restructurings described above increased the allowance for loan losses by \$0 and resulted in charge-offs of \$0 during the three months ending September 30, 2013.



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## NOTE 5 - Loans (continued)

The following tables present loans by class modified as troubled debt restructurings that occurred during the nine months ending September 30, 2014 and 2013:

September 30, 2014	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial and Industrial Loans and Leases	—	\$—	\$—
Commercial Real Estate Loans	1	201	197
Total	1	\$201	\$197

The troubled debt restructurings described above increased the allowance for loan losses by \$0 and resulted in charge-offs of \$0 during the nine months ending September 30, 2014.

September 30, 2013	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial and Industrial Loans and Leases	1	\$224	\$230
Commercial Real Estate Loans	1	81	118
Total	2	\$305	\$348

The troubled debt restructurings described above decreased the allowance for loan losses by \$210 and resulted in charge-offs of \$0 during the nine months ending September 30, 2013.

The following tables present loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the three months ending September 30, 2014 and 2013:

Troubled Debt Restructurings That Subsequently Defaulted: September 30, 2014	Number of Loans	Recorded Investment
Commercial and Industrial Loans and Leases	—	\$—
Commercial Real Estate Loans	1	186
Total	1	\$186

The troubled debt restructurings that subsequently defaulted described above resulted in no change to the allowance for loan losses and no charge-offs during the three months ending September 30, 2014.

Troubled Debt Restructurings That Subsequently Defaulted: September 30, 2013	Number of Loans	Recorded Investment
Commercial and Industrial Loans and Leases	—	\$—
Commercial Real Estate Loans	—	—
Total	—	\$—

The troubled debt restructurings that subsequently defaulted described above resulted in no change to the allowance for loan losses and no charge-offs during the three months ending September 30, 2013.





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NOTE 5 - Loans (continued)

The following tables present loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the nine months ending September 30, 2014 and 2013:

Troubled Debt Restructurings That Subsequently Defaulted: September 30, 2014	Number of Loans	Recorded Investment
Commercial and Industrial Loans and Leases	—	\$—
Commercial Real Estate Loans	1	186
Total	1	\$186

The troubled debt restructurings that subsequently defaulted described above resulted in no change to the allowance for loan losses and no charge-offs during the nine months ending September 30, 2014.

Troubled Debt Restructurings That Subsequently Defaulted: September 30, 2013	Number of Loans	Recorded Investment
Commercial and Industrial Loans and Leases	—	\$—
Commercial Real Estate Loans	—	—
Total	—	\$—

The troubled debt restructurings that subsequently defaulted described above resulted in no change to the allowance for loan losses and no charge-offs during the nine months ending September 30, 2013.

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company classifies loans as to credit risk by individually analyzing loans. This analysis includes commercial and industrial loans, commercial real estate loans, and agricultural loans with an outstanding balance greater than \$100. This analysis is typically performed on at least an annual basis. The Company uses the following definitions for risk ratings:

**Special Mention.** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts,

conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. Based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

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NOTE 5 - Loans (continued)

September 30, 2014	Pass	Special Mention	Substandard	Doubtful	Total
Commercial and Industrial Loans and Leases	\$347,901	\$18,465	\$12,354	\$—	\$378,720
Commercial Real Estate Loans	548,043	22,959	16,364	—	587,366
Agricultural Loans	199,283	5,046	463	—	204,792
Total	\$1,095,227	\$46,470	\$29,181	\$—	\$1,170,878
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	\$641	\$1,748	\$4,722	\$—	\$7,111

  

December 31, 2013	Pass	Special Mention	Substandard	Doubtful	Total
Commercial and Industrial Loans and Leases	\$324,685	\$15,485	\$11,733	\$—	\$351,903
Commercial Real Estate Loans	539,533	20,168	23,903	—	583,604
Agricultural Loans	192,609	2,357	205	—	195,171
Total	\$1,056,827	\$38,010	\$35,841	\$—	\$1,130,678
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	\$3,121	\$661	\$9,070	\$—	\$12,852

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For home equity, consumer and residential mortgage loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in home equity, consumer and residential mortgage loans based on payment activity as of September 30, 2014 and December 31, 2013:

September 30, 2014	Home Equity Loans	Consumer Loans	Residential Mortgage Loans
Performing	\$85,166	\$48,547	\$136,077
Nonperforming	308	190	1,582
Total	\$85,474	\$48,737	\$137,659
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	\$—	\$122	\$1,498

  

December 31, 2013	Home Equity Loans	Consumer Loans	Residential Mortgage Loans
Performing	\$81,698	\$49,029	\$127,708
Nonperforming	114	236	1,339
Total	\$81,812	\$49,265	\$129,047
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	\$—	\$134	\$1,767



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## NOTE 5 - Loans (continued)

The Company has purchased loans, for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The recorded investment of those loans is as follows:

	September 30, 2014
Commercial and Industrial Loans	\$387
Commercial Real Estate Loans	6,724
Home Equity Loans	—
Consumer Loans	122
Residential Mortgage Loans	1,498
Total	\$8,731
Carrying Amount, Net of Allowance	\$8,699
	December 31, 2013
Commercial and Industrial Loans	\$1,981
Commercial Real Estate Loans	10,871
Home Equity Loans	—
Consumer Loans	134
Residential Mortgage Loans	1,767
Total	\$14,753
Carrying Amount, Net of Allowance	\$14,745

Accretable yield, or income expected to be collected, is as follows:

	2014	2013
Balance at July 1	\$2,637	\$182
New Loans Purchased	—	—
Accretion of Income	(89	) (443
Reclassifications from Non-accretable Difference	—	444
Charge-off of Accretable Yield	(113	) —
Balance at September 30	\$2,435	\$183

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## NOTE 5 - Loans (continued)

Accretable yield, or income expected to be collected, is as follows:

	2014	2013
Balance at January 1	\$2,790	\$170
New Loans Purchased	—	—
Accretion of Income	(242	) (889
Reclassifications from Non-accretable Difference	—	) 902
Charge-off of Accretable Yield	(113	) —
Balance at September 30	\$2,435	\$183

For those purchased loans disclosed above, the Company increased the allowance for loan losses by \$27 during the three and nine months ended September 30, 2014. For those purchased loans disclosed above, the Company decreased the allowance for loan losses by \$141 and \$80 during the three and nine months ended September 30, 2013. No allowances for loan losses were reversed during the reported periods.

## NOTE 6 – Segment Information

The Company's operations include three primary segments: core banking, trust and investment advisory services, and insurance operations. The core banking segment involves attracting deposits from the general public and using such funds to originate consumer, commercial and agricultural, commercial and agricultural real estate, and residential mortgage loans, primarily in the Company's local markets. The core banking segment also involves the sale of residential mortgage loans in the secondary market. The trust and investment advisory services segment involves providing trust, investment advisory, and brokerage services to customers. The insurance segment offers a full range of personal and corporate property and casualty insurance products, primarily in the Company's banking subsidiary's local markets.

The core banking segment is comprised by the Company's banking subsidiary, German American Bancorp, which operated through 37 banking offices at September 30, 2014. Net interest income from loans and investments funded by deposits and borrowings is the primary revenue for the core-banking segment. The trust and investment advisory services segment's revenues are comprised primarily of fees generated by German American Financial Advisors & Trust Company. These fees are derived by providing trust, investment advisory, and brokerage services to its customers. The insurance segment primarily consists of German American Insurance, Inc., which provides a full line of personal and corporate insurance products. Commissions derived from the sale of insurance products are the primary source of revenue for the insurance segment.

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## NOTE 6 - Segment Information (continued)

The following segment financial information has been derived from the internal financial statements of German American Bancorp, Inc., which are used by management to monitor and manage the financial performance of the Company. The accounting policies of the three segments are the same as those of the Company. The evaluation process for segments does not include holding company income and expense. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the column labeled "Other" below, along with amounts to eliminate transactions between segments.

	Core Banking	Trust and Investment Advisory Services	Insurance	Other	Consolidated Totals
Three Months Ended					
September 30, 2014					
Net Interest Income	\$18,908	\$4	\$1	\$(122)	) \$18,791
Net Gains on Sales of Loans	613	—	—	—	613
Net Gains on Securities	567	—	—	—	567
Trust and Investment Product Fees	2	899	—	—	901
Insurance Revenues	15	22	1,702	—	1,739
Noncash Items:					
Provision for Loan Losses	—	—	—	—	—
Depreciation and Amortization	1,120	5	26	38	1,189
Income Tax Expense (Benefit)	3,496	(15)	) 147	(190)	) 3,438
Segment Profit (Loss)	7,540	(30)	) 216	(18)	) 7,708
Segment Assets at September 30, 2014	2,213,848	11,452	6,442	(25,821)	) 2,205,921
	Core Banking	Trust and Investment Advisory Services	Insurance	Other	Consolidated Totals
Three Months Ended					
September 30, 2013					
Net Interest Income	\$17,334	\$5	\$4	\$(151)	) \$17,192
Net Gains on Sales of Loans	613	—	—	—	613
Net Gains on Securities	415	—	—	13	428
Trust and Investment Product Fees	1	802	—	(1)	) 802
Insurance Revenues	10	7	1,478	—	1,495
Noncash Items:					
Provision for Loan Losses	(400)	) —	—	—	(400)
Depreciation and Amortization	941	6	99	38	1,084
Income Tax Expense (Benefit)	3,218	(24)	) 67	(292)	) 2,969
Segment Profit (Loss)	6,581	(41)	) 96	(153)	) 6,483
Segment Assets at December 31, 2013	2,171,837	11,663	5,636	(25,309)	) 2,163,827





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## NOTE 6 - Segment Information (continued)

	Core Banking	Trust and Investment Advisory Services	Insurance	Other	Consolidated Totals
Nine Months Ended September 30, 2014					
Net Interest Income	\$55,655	\$12	\$3	\$(362)	) \$55,308
Net Gains on Sales of Loans	1,475	—	—	—	1,475
Net Gains on Securities	1,039	—	—	—	1,039
Trust and Investment Product Fees	4	2,724	—	—	2,728
Insurance Revenues	20	33	5,724	—	5,777
Noncash Items:					
Provision for Loan Losses	550	—	—	—	550
Depreciation and Amortization	3,395	18	85	113	3,611
Income Tax Expense (Benefit)	8,940	(122)	) 747	(598)	) 8,967
Segment Profit (Loss)	19,908	(202)	) 1,078	(84)	) 20,700
Segment Assets at September 30, 2014	2,213,848	11,452	6,442	(25,821)	) 2,205,921

	Core Banking	Trust and Investment Advisory Services	Insurance	Other	Consolidated Totals
Nine Months Ended September 30, 2013					
Net Interest Income	\$51,102	\$16	\$16	\$(1,005)	) \$50,129
Net Gains on Sales of Loans	2,176	—	—	—	2,176
Net Gains on Securities	1,495	—	—	13	1,508
Trust and Investment Product Fees	5	2,430	—	(2)	) 2,433
Insurance Revenues	25	26	4,607	—	4,658
Noncash Items:					
Provision for Loan Losses	(250)	) —	—	—	(250)
Depreciation and Amortization	2,864	21	310	113	3,308
Income Tax Expense (Benefit)	9,588	(50)	) 254	(1,080)	) 8,712
Segment Profit (Loss)	19,262	(90)	) 334	(682)	) 18,824
Segment Assets at December 31, 2013	2,171,837	11,663	5,636	(25,309)	) 2,163,827

## NOTE 7 – Stock Repurchase Plan

On April 26, 2001 the Company announced that its Board of Directors approved a stock repurchase program for up to 607,754 of the outstanding Common Shares of the Company. Shares may be purchased from time to time in the open market and in large block privately negotiated transactions. The Company is not obligated to purchase any shares under the program, and the program may be discontinued at any time before the maximum number of shares specified by the program are purchased. The Board of Directors established no expiration date for this program. As of

September 30, 2014, the Company had purchased 334,965 shares under the program. No shares were purchased under the program during the three and nine months ended September 30, 2014 and 2013.

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NOTE 8 – Equity Plans and Equity Based Compensation

The Company maintains three equity incentive plans under which stock options, restricted stock, and other equity incentive awards can be granted. At September 30, 2014, the Company has reserved 438,813 shares of Common Stock (as adjusted for subsequent stock dividends and subject to further customary anti-dilution adjustments) for the purpose of issuance pursuant to outstanding and future grants of options, restricted stock, and other equity awards to officers, directors and other employees of the Company.

For the three and nine months ended September 30, 2014 and 2013, the Company granted no options, and accordingly, recorded no stock option expense related to option grants during the three and nine months ended September 30, 2014 and 2013. The Company recorded no other stock compensation expense applicable to options during the three and nine months ended September 30, 2014 and 2013 because all outstanding options were fully vested prior to 2007. In addition, there was no unrecognized option expense as all outstanding options were fully vested prior to September 30, 2014 and 2013.

During the periods presented, awards of long-term incentives were granted in the form of restricted stock. Awards that were granted to management under a management incentive plan were granted in tandem with cash credit entitlements (in the form of 60% restricted stock grants and 40% cash credit entitlements for 2014 and 50% restricted stock grants and 50% cash credit entitlements prior to 2014). The management restricted stock grants and tandem cash credit entitlements awarded in 2013 will vest in three equal installments of 33.3% with the first annual vesting on December 5th of the year of the grant and on December 5th of the next two succeeding years. Awards that were granted to directors as additional retainer for their services do not include any cash credit entitlement. These director restricted stock grants are subject to forfeiture in the event that the recipient of the grant does not continue in service as a director of the Company through December 5th of the year after grant or do not satisfy certain meeting attendance requirements, at which time they generally vest 100 percent. For measuring compensation costs, restricted stock awards are valued based upon the market value of the common shares on the date of grant. During the three months ended September 30, 2014 and 2013, the Company granted no shares of restricted stock. During the nine months ended September 30, 2014 and 2013, the Company granted awards of 31,080 and 29,170 shares of restricted stock, respectively.

The following tables present expense recorded for restricted stock and cash entitlements as well as the related tax effect for the periods presented:

	Three Months Ended September 30,	
	2014	2013
Restricted Stock Expense	\$ 161	\$ 77
Cash Entitlement Expense	101	54
Tax Effect	(106	) (53
Net of Tax	\$ 156	\$ 78
	Nine Months Ended September 30,	
	2014	2013

Restricted Stock Expense	\$482	\$247
Cash Entitlement Expense	300	162
Tax Effect	(317	) (166
Net of Tax	\$465	\$243

Unrecognized expense associated with the restricted stock grants and cash entitlements totaled \$1,616 and \$971 as of September 30, 2014 and 2013, respectively.

The Company maintains an Employee Stock Purchase Plan whereby eligible employees have the option to purchase the Company's common stock at a discount. The purchase price of the shares under this Plan has been set at 95% of the fair market value of the Company's common stock as of the last day of the plan year. The plan provided for the purchase of up to 500,000 shares of common stock, which the Company may obtain by purchases on the open market or from private sources, or by issuing authorized but unissued common shares. Funding for the purchase of common stock is from employee and Company contributions.

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NOTE 8 - Equity Plans and Equity Based Compensation (continued)

The Employee Stock Purchase Plan is not considered compensatory. There was no expense recorded for the employee stock purchase plan during the three and nine months ended September 30, 2014 and 2013, nor was there any unrecognized compensation expense as of September 30, 2014 and 2013 for the Employee Stock Purchase Plan.

NOTE 9 – Fair Value

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

**Investment Securities:** The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Level 3 pricing is obtained from a third-party based upon similar trades that are not traded frequently without adjustment by the Company. At September 30, 2014, the Company held \$10.5 million in Level 3 securities which consist of \$10.1 million of non-rated Obligations of State and Political Subdivisions and \$353 thousand of equity securities that are not actively traded. Absent the credit rating, significant assumptions must be made such that the credit risk input becomes an unobservable input and thus these securities are reported by the Company in a Level 3 classification.

**Derivatives:** The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2).

**Impaired Loans:** Fair values for impaired collateral dependent loans are generally based on appraisals obtained from licensed real estate appraisers and in certain circumstances consideration of offers obtained to purchase properties prior to foreclosure. Appraisals for commercial real estate generally use three methods to derive value: cost, sales or market comparison and income approach. The cost method bases value in the cost to replace the current property. Value of market comparison approach evaluates the sales price of similar properties in the same market

area. The income approach considers net operating income generated by the property and an investors required return. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Comparable sales adjustments are based on known sales prices of similar type and similar use properties and duration of time that the property has been on the market to sell. Such adjustments made in the appraisal process are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the Company's Risk Management Area reviews the assumptions and approaches utilized in the appraisal. In determining the value of impaired collateral dependent loans and other real estate owned, significant unobservable inputs may be used which include: physical condition of comparable properties sold, net operating income generated by the property and investor rates of return.

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NOTE 9 - Fair Value (continued)

Other Real Estate: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate (ORE) are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property utilizing similar techniques as discussed above for Impaired Loans, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, impairment loss is recognized.

Loans Held-for-Sale: The fair values of loans held for sale are determined by using quoted prices for similar assets, adjusted for specific attributes of that loan resulting in a Level 2 classification.

Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis, including financial assets and liabilities for which the Company has elected the fair value option, are summarized below:

	Fair Value Measurements at September 30, 2014 Using			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:				
U.S. Treasury and Agency Securities	\$—	\$19,363	\$—	\$19,363
Corporate Securities	—	—	—	—
Obligations of State and Political Subdivisions	—	130,409	10,120	140,529
Mortgage-backed Securities-Residential	—	415,496	—	415,496
Equity Securities	—	—	353	353
Total Securities	\$—	\$565,268	\$10,473	\$575,741
Loans Held-for-Sale	\$—	\$7,590	\$—	\$7,590
Derivative Assets	\$—	\$470	\$—	\$470
Derivative Liabilities	\$—	\$412	\$—	\$412

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## NOTE 9 - Fair Value (continued)

	Fair Value Measurements at December 31, 2013 Using				Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
Assets:					
U.S. Treasury and Agency Securities	\$—	\$18,952	\$—		\$18,952
Corporate Securities	—	—	—		—
Obligations of State and Political Subdivisions	—	102,665	10,832		113,497
Mortgage-backed Securities-Residential	—	473,230	—		473,230
Equity Securities	—	—	353		353
Total Securities	\$—	\$594,847	\$11,185		\$606,032
Loans Held-for-Sale	\$—	\$9,265	\$—		\$9,265
Derivative Assets	\$—	\$866	\$—		\$866
Derivative Liabilities	\$—	\$737	\$—		\$737

There were no transfers between Level 1 and Level 2 for the periods ended September 30, 2014 and December 31, 2013.

At September 30, 2014, the aggregate fair value of the Loans Held-for-Sale was \$7,590, aggregate contractual principal balance was \$7,433 with a difference of \$157. At December 31, 2013, the aggregate fair value of the Loans Held-for-Sale was \$9,265, aggregate contractual principle balance was \$9,129 with a difference of \$136.

The tables below present a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2014 and 2013:

	Obligations of State and Political Subdivisions		Equity Securities		Corporate Securities	
	2014	2013	2014	2013	2014	2013
Balance of Recurring Level 3 Assets at July 1	\$10,562	\$11,439	\$353	\$353	\$—	\$—
Total Gains or Losses (realized/unrealized) Included in Earnings	(12 )	(12 )	—	—	—	—
Maturities / Calls	(430 )	(425 )	—	—	—	—
Purchases	—	—	—	—	—	—
Balance of Recurring Level 3 Assets at September 30	\$10,120	\$11,002	\$353	\$353	\$—	\$—





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NOTE 9 - Fair Value (continued)

	Obligations of State and Political Subdivisions		Equity Securities		Corporate Securities	
	2014	2013	2014	2013	2014	2013
Balance of Recurring Level 3 Assets at January 1	\$10,832	\$12,169	\$353	\$353	\$—	\$—
Total Gains or Losses (realized/unrealized) Included in Earnings	143	(162 )	—	—	—	—
Maturities / Calls	(855 )	(1,005 )	—	—	—	—
Purchases	—	—	—	—	—	—
Balance of Recurring Level 3 Assets at September 30	\$10,120	\$11,002	\$353	\$353	\$—	\$—

Of the total gain/loss included in earnings for the three and nine months ended September 30, 2014, \$(12) and \$143 was attributable to other changes in fair value. The three and nine months ended September 30, 2014 included no gain/loss attributable to interest income on securities. Of the total gain/loss included in earnings for the three and nine months ended September 30, 2013, \$(12) and \$(162) was attributable to other changes in fair value, respectively. The three and nine months ended September 30, 2013 included no gain/loss attributable to interest income on securities.

Assets and Liabilities Measured on a Non-Recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

	Fair Value Measurements at September 30, 2014 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:				
Impaired Loans with Specific Allocations				
Commercial and Industrial Loans	\$—	\$—	\$2	\$2
Commercial Real Estate Loans	—	—	1,223	1,223
Agricultural Loans	—	—	—	—
Other Real Estate				
Commercial Real Estate	—	—	83	83
Fair Value Measurements at December 31, 2013 Using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total

Assets:

Impaired Loans with Specific Allocations

Commercial and Industrial Loans	\$—	\$—	\$—	\$—
Commercial Real Estate Loans	—	—	1,346	1,346
Agricultural Loans	—	—	—	—
Other Real Estate				
Commercial Real Estate	—	—	20	20

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$2,809 with a valuation allowance of \$1,584, resulting in an additional provision for loan losses of \$30 and

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## NOTE 9 - Fair Value (continued)

\$187 for the three and nine months ended September 30, 2014, respectively. For the three and nine months ended September 30, 2013, impaired loans resulted in an additional provision for loan losses of \$229 and \$608, respectively. Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$4,449 with a valuation allowance of \$3,103, resulting in an additional provision for loan losses of \$1,024 for the year ended December 31, 2013.

Other Real Estate is measured at the lower of carrying or fair value less costs to sell had a carrying value of \$83 at September 30, 2014. A charge to earnings through Other Operating Income of \$83 was included in the three and nine months ended September 2014. No charge to earnings was included in the three months ended September 30, 2013. A charge to earnings through Other Operating Income of \$301 was included in the nine months ended September 30, 2013. Other Real Estate which is measured at the lower of carrying or fair value less costs to sell had a carrying value of \$20 at December 31, 2013.

The following tables present quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2014 and December 31, 2013:

September 30, 2014	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired Loans - Commercial and Industrial Loans	\$2	Sales comparison approach	Adjustment for differences between comparable sales	52%-90% (71%)
Impaired Loans - Commercial Real Estate Loans	\$1,223	Sales comparison approach	Adjustment for physical condition of comparable properties sold	12%-80% (63%)
		Income approach	Adjustment for net operating income generated by the property	
		Cost approach	Adjustment for investor rates of return	
Other Real Estate - Commercial Real Estate Loans	\$83	Sales comparison approach	Adjustment for physical condition of comparable properties sold	55% (55%)
		Income approach	Adjustment for net operating income generated by the property	
		Cost approach	Adjustment for investor rates of return	

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## NOTE 9 - Fair Value (continued)

December 31, 2013	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired Loans - Commercial Real Estate Loans	\$1,346	Sales comparison approach	Adjustment for physical condition of comparable properties sold	12%-80% (53%)
		Income approach	Adjustment for net operating income generated by the property	
		Cost approach	Adjustment for investor rates of return	
Other Real Estate - Commercial Real Estate Loans	\$20	Sales comparison approach	Adjustment for physical condition of comparable properties sold	50% (50%)
		Income approach	Adjustment for net operating income generated by the property	
		Cost approach	Adjustment for investor rates of return	

The carrying amounts and estimated fair values of the Company's financial instruments not previously presented are provided in the tables below for the periods ending September 30, 2014 and December 31, 2013. Not all of the Company's assets and liabilities are considered financial instruments, and therefore are not included in the table. Because no active market exists for a significant portion of the Company's financial instruments, fair value estimates were based on subjective judgments, and therefore cannot be determined with precision.

	Fair Value Measurements at September 30, 2014 Using				
	Carrying Value	Level 1	Level 2	Level 3	Total
<b>Financial Assets:</b>					
Cash and Short-term Investments	\$87,267	\$37,427	\$49,840	\$—	\$87,267
Securities Held-to-Maturity	184	—	186	—	186
FHLB Stock and Other Restricted Stock	9,096	N/A	N/A	N/A	N/A
Loans, Net	1,415,932	—	—	1,414,237	1,414,237
Accrued Interest Receivable	8,296	—	2,233	6,063	8,296
<b>Financial Liabilities:</b>					
Demand, Savings, and Money Market Deposits	(1,430,833 )	(1,430,833 )	—	—	(1,430,833 )
Time Deposits	(333,638 )	—	(329,839 )	—	(329,839 )
Short-term Borrowings	(120,510 )	—	(120,510 )	—	(120,510 )
Long-term Debt	(87,576 )	—	(83,331 )	(5,387 )	(88,718 )
Accrued Interest Payable	(673 )	—	(625 )	(48 )	(673 )
<b>Unrecognized Financial Instruments:</b>					

Commitments to Extend Credit	—	—	—	—	—
Standby Letters of Credit	—	—	—	—	—
Commitments to Sell Loans	—	—	—	—	—

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## NOTE 9 - Fair Value (continued)

	Carrying Value	Fair Value Measurements at December 31, 2013 Using			Total
		Level 1	Level 2	Level 3	
<b>Financial Assets:</b>					
Cash and Short-term Investments	\$60,232	\$37,370	\$22,862	\$—	\$60,232
Securities Held-to-Maturity	268	—	271	—	271
FHLB Stock and Other Restricted Stock	9,004	N/A	N/A	N/A	N/A
Loans, Net	1,366,452	—	—	1,370,339	1,370,339
Accrued Interest Receivable	7,470	—	1,918	5,552	7,470
<b>Financial Liabilities:</b>					
Demand, Savings, and Money Market Deposits	(1,463,122 )	(1,463,122 )	—	—	(1,463,122 )
Time Deposits	(349,034 )	—	(351,707 )	—	(351,707 )
Short-term Borrowings	(53,533 )	—	(53,533 )	—	(53,533 )
Long-term Debt	(87,237 )	—	(83,329 )	(5,311 )	(88,640 )
Accrued Interest Payable	(777 )	—	(732 )	(45 )	(777 )
<b>Unrecognized Financial Instruments:</b>					
Commitments to Extend Credit	—	—	—	—	—
Standby Letters of Credit	—	—	—	—	—
Commitments to Sell Loans	—	—	—	—	—

**Cash and Short-term Investments:**

The carrying amount of cash and short-term investments approximate fair values and are classified as Level 1 or Level 2.

**Securities Held-to-Maturity:**

The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2).

**FHLB Stock and Other Restricted Stock:**

It is not practical to determine the fair values of FHLB stock and other restricted stock due to restrictions placed on their transferability.

**Loans:**

Fair values of loans, excluding loans held for sale and collateral dependent impaired loans having a specific allowance allocation, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued as described previously. The methods utilized to estimate fair value of loans do not necessarily represent an exit price.

**Accrued Interest Receivable:**

The carrying amount of accrued interest approximates fair value resulting in a Level 2 or Level 3 classification consistent with the asset they are associated with.

Deposits:

The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. Fair values for fixed rate time deposits are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.



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NOTE 9 - Fair Value (continued)

Short-term Borrowings:

The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings, generally maturing within ninety days, approximate their fair values resulting in a Level 2 classification.

Long-term Debt:

The fair values of the Company's long-term borrowings are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

The fair values of the Company's subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Accrued Interest Payable:

The carrying amount of accrued interest approximates fair value resulting in a Level 2 or Level 3 classification consistent with the liability they are associated with.

Off-balance Sheet Instruments:

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

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## NOTE 10 – Other Comprehensive Income (Loss)

The tables below summarize the changes in accumulated other comprehensive income (loss) by component for the three and nine months ended September 30, 2014, net of tax:

	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Postretirement Benefit Items	Total
Beginning Balance at July 1, 2014	\$ (130 )	\$—	\$(32 )	\$(162 )
Other Comprehensive Income (Loss) Before Reclassification	577	—	—	577
Amounts Reclassified from Accumulated Other Comprehensive Income (Loss)	(369 )	—	—	(369 )
Net Current Period Other Comprehensive Income (Loss)	208	—	—	208
Ending Balance at September 30, 2014	\$ 78	\$—	\$(32 )	\$46
	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Postretirement Benefit Items	Total
Beginning Balance at January 1, 2014	\$ (5,231 )	\$—	\$(32 )	\$(5,263 )
Other Comprehensive Income (Loss) Before Reclassification	5,984	—	—	5,984
Amounts Reclassified from Accumulated Other Comprehensive Income (Loss)	(675 )	—	—	(675 )
Net Current Period Other Comprehensive Income (Loss)	5,309	—	—	5,309
Ending Balance at September 30, 2014	\$ 78	\$—	\$(32 )	\$46

The tables below summarize the changes in accumulated other comprehensive income (loss) by component for the three and nine months ended September 30, 2013, net of tax:

	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Postretirement Benefit Items	Total
Beginning Balance at July 1, 2013	\$ (1,247 )	\$(231 )	\$(61 )	\$(1,539 )
Other Comprehensive Income (Loss) Before Reclassification	(1,134 )	—	—	(1,134 )
Amounts Reclassified from Accumulated Other Comprehensive Income (Loss)	(239 )	—	—	(239 )
Net Current Period Other Comprehensive Income (Loss)	(1,373 )	—	—	(1,373 )
Ending Balance at September 30, 2013	\$ (2,620 )	\$(231 )	\$(61 )	\$(2,912 )



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## NOTE 10 - Other Comprehensive Income (Loss) (continued)

	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Postretirement Benefit Items	Total
Beginning Balance at January 1, 2013	\$ 10,643	\$(231 )	\$(61 )	\$ 10,351
Other Comprehensive Income (Loss) Before Reclassification	(12,192 )	—	—	(12,192 )
Amounts Reclassified from Accumulated Other Comprehensive Income (Loss)	(1,071 )	—	—	(1,071 )
Net Current Period Other Comprehensive Income (Loss)	(13,263 )	—	—	(13,263 )
Ending Balance at September 30, 2013	\$ (2,620 )	\$(231 )	\$(61 )	\$(2,912 )

The tables below summarize the classifications out of accumulated other comprehensive income (loss) by component for the three and nine months ended September 30, 2014:

Details about Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified From Accumulated Other Comprehensive Income (Loss)	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	\$ (567 )	Net (Gain) Loss on Securities
	198	Income Tax Expense
	(369 )	Net of Tax
Total Reclassifications for the Three Months Ended September 30, 2014	\$(369 )	
Details about Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified From Accumulated Other Comprehensive Income (Loss)	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	\$ (1,039 )	Net (Gain) Loss on Securities
	364	Income Tax Expense
	(675 )	Net of Tax
Total Reclassifications for the Nine Months Ended September 30, 2014	\$(675 )	

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NOTE 10 - Other Comprehensive Income (Loss) (continued)

The tables below summarize the classifications out of accumulated other comprehensive income (loss) by component for the three and nine months ended September 30, 2013:

Details about Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified From Accumulated Other Comprehensive Income (Loss)	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	\$(428)	) Net (Gain) Loss on Securities
	189	Income Tax Expense
	(239)	) Net of Tax
Total Reclassifications for the Three Months Ended September 30, 2013	\$(239)	)

Details about Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified From Accumulated Other Comprehensive Income (Loss)	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	\$(1,508)	) Net (Gain) Loss on Securities
	437	Income Tax Expense
	(1,071)	) Net of Tax
Total Reclassifications for the Nine Months Ended September 30, 2013	\$(1,071)	)

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

### GERMAN AMERICAN BANCORP, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

German American Bancorp, Inc., is a NASDAQ-traded (symbol: GABC) financial services holding company based in Jasper, Indiana. German American, through its banking subsidiary German American Bancorp, operates 37 commercial and retail banking offices in 13 southern Indiana counties. The Company also owns a trust, brokerage, and financial planning subsidiary (German American Financial Advisors & Trust Company) and a full line property and casualty insurance agency (German American Insurance, Inc.).

Throughout this Management's Discussion and Analysis, as elsewhere in this report, when we use the term "Company," we will usually be referring to the business and affairs (financial and otherwise) of the Company and its subsidiaries and affiliates as a whole. Occasionally, we will refer to the term "parent company" or "holding company" when we mean to refer to only German American Bancorp, Inc.

This section presents an analysis of the consolidated financial condition of the Company as of September 30, 2014 and December 31, 2013 and the consolidated results of operations for the three and nine months ended September 30, 2014 and 2013. This discussion should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein and with the financial statements and other financial data, as well as the Management's Discussion and Analysis of Financial Condition and Results of Operations, included in the Company's December 31, 2013 Annual Report on Form 10-K.

### MANAGEMENT OVERVIEW

This updated discussion should be read in conjunction with the Management Overview that was included in our Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's December 31, 2013 Annual Report on Form 10-K and in the Company's Quarterly Reports on Form 10-Q for the quarters ended March 31, 2014 and June 30, 2014.

Net income for the quarter ended September 30, 2014 improved by \$1,225,000 to \$7,708,000, or \$0.58 per share, as compared to the quarter ended September 30, 2013 net income of \$6,483,000, or \$0.51 per share representing an increase of 14% on a per share basis. On a year-to-date basis, 2014 earnings improved to \$20,700,000 or \$1.57 per diluted share, as compared to \$18,824,000, or \$1.48 per diluted share for the first nine months of 2013 representing an increase of approximately 6% on a per share basis.

The Company's third quarter and year-to-date 2014 earnings were positively impacted by improved levels of net interest income and non-interest income as compared with the same periods of 2013. Net interest income increased \$1,599,000, or 9%, and \$5,179,000, or 10%, in the three and nine months ended September 30, 2014 compared with the same periods of 2013. This improvement in both periods was driven by a higher level of earning assets due in large part to an increased loan portfolio and to an improved net interest margin. Non-interest income also increased \$993,000, or 18%, and \$756,000, or 4%, in the three and nine months ended September 30, 2014 compared with the same periods of 2013.

Partially mitigating the improvement in net interest income and non-interest income was an increased level of operating costs during the third quarter and first nine months of 2014 compared with the same periods of 2013. Operating expenses for the third quarter of 2014 increased \$498,000, or 4%, and for the first nine months of 2014 increased \$3,004,000, or 7%, as compared to the same periods of 2013. The increase in non-interest expenses was largely impacted by the inclusion of the United Commerce Bancorp operations which was acquired by the Company effective October 1, 2013, a new financial center in Columbus, Indiana, and the implementation of new digital banking systems.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The financial condition and results of operations for German American Bancorp, Inc. presented in the Consolidated Financial Statements, accompanying Notes to the Consolidated Financial Statements, and selected financial data appearing elsewhere within this Report, are, to a large degree, dependent upon the Company's accounting policies. The selection of and application of these policies involve estimates, judgments, and uncertainties that are subject to change. The critical accounting policies and estimates that the Company has determined to be the most susceptible to change in the near term relate to the determination of the allowance for loan losses, the valuation of securities available for sale, and the valuation allowance on deferred tax assets.

### Allowance for Loan Losses

The Company maintains an allowance for loan losses to cover probable incurred credit losses at the balance sheet date. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. A provision for loan losses is charged to operations based on management's periodic evaluation of the necessary allowance balance. Evaluations are conducted at least quarterly and more often if deemed necessary. The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control.

The Company has an established process to determine the adequacy of the allowance for loan losses. The determination of the allowance is inherently subjective, as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on other classified loans and pools of homogeneous loans, and consideration of past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors, all of which may be susceptible to significant change. The allowance consists of two components of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover losses inherent in the loan portfolio.

Commercial and agricultural loans are subject to a standardized grading process administered by an internal loan review function. The need for specific reserves is considered for credits when graded impaired or when: (a) the customer's cash flow or net worth appears insufficient to repay the loan; (b) the loan has been criticized in a regulatory examination; (c) the loan is on non-accrual; or, (d) other reasons where the ultimate collectability of the loan is in question, or the loan characteristics require special monitoring. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that we believe indicates the loan is impaired.

Specific allocations on impaired loans are determined by comparing the loan balance to the present value of expected cash flows or expected collateral proceeds. Allocations are also applied to categories of loans not considered individually impaired but for which the rate of loss is expected to be greater than historical averages, including those graded substandard and non-performing consumer or residential real estate loans. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values.

During the third quarter of 2014, a modification was made to the Company's standard methodology for calculating the allowance for loan losses. This modification centered on commercial and agricultural loans that are graded as substandard and was undertaken as a part of the Company's annual update of its migration analysis utilized in the allowance for loan losses calculations. Prior to the third quarter of 2014, the allocation for substandard, non-impaired commercial and agricultural loans was based on evaluating the amount of loss of each individual credit relationship



internally graded substandard. Beginning in the third quarter of 2014, the Company adjusted its methodology to assign allocations for substandard commercial and agricultural credits based on migration analysis techniques utilizing three year migration periods for these types of credits. The modification to the methodology during the third quarter of 2014 resulted in a decrease of \$63,000 to the overall required loan loss allowance.

General allocations are made for other pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a three-year historical average for loan losses for these portfolios, judgmentally adjusted for economic, external and internal factors and portfolio trends. Economic factors include evaluating changes in international, national, regional and local economic and business conditions that affect the collectability of the loan portfolio. Internal factors include evaluating changes in lending policies and procedures; changes in the nature and volume of the loan portfolio; and changes in experience, ability and depth of lending management and staff. In setting our external and internal factors we also consider the overall level of the allowance for loan losses to total loans; our allowance coverage as compared to similar size bank holding companies; and regulatory requirements.

Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses includes a minor unallocated component. The unallocated component of the allowance for loan losses incorporates the Company's judgmental determination of inherent losses that may not be fully reflected in other allocations, including factors such as economic uncertainties, lending staff quality, industry trends impacting specific portfolio segments, and broad portfolio quality trends. Therefore, the ratio of allocated to unallocated components within the total allowance may fluctuate from period to period.

#### Securities Valuation

Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported separately in accumulated other comprehensive income (loss), net of tax. The Company obtains market values from a third party on a monthly basis in order to adjust the securities to fair value. Equity securities that do not have readily determinable fair values are carried at cost. Additionally, when securities are deemed to be other than temporarily impaired, a charge will be recorded through earnings; therefore, future changes in the fair value of securities could have a significant impact on the Company's operating results. In determining whether a market value decline is other than temporary, management considers the reason for the decline, the extent of the decline, the duration of the decline and whether the Company intends to sell or believes it will be required to sell the securities prior to recovery. As of September 30, 2014, gross unrealized losses on the securities available-for-sale portfolio totaled approximately \$8,457,000 and gross unrealized gains totaled approximately \$8,616,000. As of September 30, 2014, held-to-maturity securities had a gross unrecognized gain of approximately \$2,000.

#### Income Tax Expense

Income tax expense involves estimates related to the valuation allowance on deferred tax assets and loss contingencies related to exposure from tax examinations.

A valuation allowance reduces deferred tax assets to the amount management believes is more likely than not to be realized. In evaluating the realization of deferred tax assets, management considers the likelihood that sufficient taxable income of appropriate character will be generated within carryback and carryforward periods, including consideration of available tax planning strategies. Tax related loss contingencies, including assessments arising from tax examinations and tax strategies, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. In considering the likelihood of loss, management considers the nature of the contingency, the progress of any examination or related protest or appeal, the views of legal counsel and other advisors, experience of the Company or other enterprises in similar matters, if any, and management's intended response to any assessment.

## RESULTS OF OPERATIONS

### Net Income:

Net income for the quarter ended September 30, 2014 improved by \$1,225,000 to \$7,708,000, or \$0.58 per share, as compared to the quarter ended September 30, 2013 net income of \$6,483,000, or \$0.51 per share representing an increase of 14% on a per share basis. On a year-to-date basis, 2014 earnings improved to \$20,700,000 or \$1.57 per diluted share, as compared to \$18,824,000, or \$1.48 per diluted share for the first nine months of 2013 representing an increase of approximately 6% on a per share basis.

## Net Interest Income:

Net interest income is the Company's single largest source of earnings, and represents the difference between interest and fees realized on earning assets, less interest paid on deposits and borrowed funds. Several factors contribute to the determination of net interest income and net interest margin, including the volume and mix of earning assets, interest rates, and income taxes. Many factors affecting net interest income are subject to control by management policies and actions. Factors beyond the control of management include the general level of credit and deposit demand, Federal Reserve Board monetary policy, and changes in tax laws.

The following table summarizes net interest income (on a tax-equivalent basis). For tax-equivalent adjustments an effective tax rate of 35% was used for all periods presented<sup>(1)</sup>.

	Average Balance Sheet (Tax-equivalent basis / dollars in thousands)						
	Three Months Ended September 30, 2014				Three Months Ended September 30, 2013		
	Principal Balance	Income / Expense	Yield / Rate		Principal Balance	Income / Expense	Yield / Rate
<b>Assets</b>							
Federal Funds Sold and Other Short-term Investments	\$15,788	\$2	0.04 %		\$11,868	\$2	0.08 %
<b>Securities:</b>							
Taxable	489,466	2,531	2.07 %		530,933	2,768	2.08 %
Non-taxable	137,632	1,746	5.07 %		86,542	1,130	5.23 %
Total Loans and Leases <sup>(2)</sup>	1,424,458	16,755	4.67 %		1,269,222	15,368	4.81 %
Total Interest Earning Assets	2,067,344	21,034	4.05 %		1,898,565	19,268	4.04 %
Other Assets	140,019				133,308		
Less: Allowance for Loan Losses	(15,879 )				(15,497 )		
Total Assets	\$2,191,484				\$2,016,376		
<b>Liabilities and Shareholders' Equity</b>							
Interest-bearing Demand, Savings and Money Market Deposits	\$1,017,266	\$317	0.12 %		\$979,049	\$387	0.16 %
Time Deposits	330,494	708	0.85 %		333,000	758	0.90 %
FHLB Advances and Other Borrowings	213,205	532	0.99 %		161,092	475	1.17 %
Total Interest-bearing Liabilities	1,560,965	1,557	0.40 %		1,473,141	1,620	0.44 %
Demand Deposit Accounts	400,223				349,323		
Other Liabilities	13,028				11,952		
Total Liabilities	1,974,216				1,834,416		
Shareholders' Equity	217,268				181,960		
Total Liabilities and Shareholders' Equity	\$2,191,484				\$2,016,376		
Cost of Funds			0.30 %				0.34 %
Net Interest Income		\$19,477				\$17,648	
Net Interest Margin			3.75 %				3.70 %

(1) Effective tax rates were determined as though interest earned on the Company's investments in municipal bonds and loans was fully taxable.

(2) Loans held-for-sale and non-accruing loans have been included in average loans.

Net interest income increased \$1,599,000 or 9% (an increase of \$1,829,000 or 10% on a tax-equivalent basis) for the quarter ended September 30, 2014 compared with the same quarter of 2013. The increased level of net interest income during the third quarter of 2014 compared with the third quarter of 2013 was driven by a higher level of earning assets and a higher net interest margin (expressed as a percentage of average earning assets).

The net interest margin represents tax-equivalent net interest income expressed as a percentage of average earning assets. The tax equivalent net interest margin was 3.75% for the third quarter of 2014 compared to 3.70% during the third quarter of 2013. The yield on earning assets totaled 4.05% during the quarter ended September 30, 2014 compared to 4.04% in the same period of 2013 while the cost of funds (expressed as a percentage of average earning assets) totaled 0.30% during the quarter ended September 30, 2014 compared to 0.34% in the same period of 2013.

The improvement of the net interest margin and net interest income in the third quarter of 2014 compared with the third quarter of 2013 was attributable to an increased level of average loans outstanding and to the continued decline in the Company's cost of funds. Accretion of loan discounts on acquired loans contributed approximately 6 basis points on an annualized basis to the net interest margin in the third quarter of 2014 and approximately 10 basis points in the third quarter of 2013.

	Average Balance Sheet (Tax-equivalent basis / dollars in thousands)					
	Nine Months Ended September 30, 2014			Nine Months Ended September 30, 2013		
	Principal Balance	Income / Expense	Yield / Rate	Principal Balance	Income / Expense	Yield / Rate
Assets						
Federal Funds Sold and Other Short-term Investments	\$13,490	\$8	0.08 %	\$14,483	\$25	0.23 %
Securities:						
Taxable	499,404	7,944	2.12 %	548,144	8,380	2.04 %
Non-taxable	125,708	4,824	5.12 %	80,480	3,089	5.12 %
Total Loans and Leases <sup>(2)</sup>	1,395,529	48,989	4.69 %	1,238,243	45,392	4.90 %
Total Interest Earning Assets	2,034,131	61,765	4.06 %	1,881,350	56,886	4.04 %
Other Assets	140,725			134,983		
Less: Allowance for Loan Losses						