

LAKELAND FINANCIAL CORP

Form 10-Q

May 12, 2014

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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 March 31, 2014

OR

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

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

LAKELAND FINANCIAL CORPORATION  
(Exact name of registrant as specified in its charter)

Indiana	0-11487	35-1559596
(State or Other Jurisdiction of Incorporation or Organization)	(Commission File Number)	(IRS Employer Identification No.)

202 East Center Street, P.O. Box 1387, Warsaw, Indiana 46581-1387  
(Address of Principal Executive Offices)(Zip Code)

(574) 267-6144  
(Registrant's Telephone Number, Including Area Code)

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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Large accelerated filer  Accelerated filer  Non-accelerated filer  (do not check if a smaller reporting company) 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

Number of shares of common stock outstanding at April 30, 2014: 16,534,617

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## ITEM 1. FINANCIAL STATEMENTS

## CONSOLIDATED BALANCE SHEETS (in thousands except share data)

	March 31, 2014 (Unaudited)	December 31, 2013
<b>ASSETS</b>		
Cash and due from banks	\$ 67,960	\$ 55,727
Short-term investments	9,179	7,378
Total cash and cash equivalents	77,139	63,105
Securities available for sale (carried at fair value)	471,449	468,967
Real estate mortgage loans held for sale	2,043	1,778
Loans, net of allowance for loan losses of \$46,137 and \$48,797	2,528,053	2,486,301
Land, premises and equipment, net	39,575	39,335
Bank owned life insurance	62,994	62,883
Federal Reserve and Federal Home Loan Bank stock	10,732	10,732
Accrued interest receivable	8,833	8,577
Goodwill	4,970	4,970
Other assets	27,936	29,116
Total assets	\$ 3,233,724	\$ 3,175,764
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Noninterest bearing deposits	\$ 482,189	\$ 479,606
Interest bearing deposits	2,256,585	2,066,462
Total deposits	2,738,774	2,546,068
Short-term borrowings		
Federal funds purchased	8,000	11,000
Securities sold under agreements to repurchase	81,361	104,876
Other short-term borrowings	25,000	146,000
Total short-term borrowings	114,361	261,876
Long-term borrowings	35	37
Subordinated debentures	30,928	30,928
Accrued interest payable	2,938	2,918
Other liabilities	14,597	11,973
Total liabilities	2,901,633	2,853,800
<b>STOCKHOLDERS' EQUITY</b>		
Common stock: 90,000,000 shares authorized, no par value		

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16,533,617 shares issued and 16,433,341 outstanding as of March 31, 2014		
16,475,716 shares issued and 16,377,449 outstanding as of December 31, 2013	93,789	93,249
Retained earnings	239,889	233,108
Accumulated other comprehensive income (loss)	454	(2,494)
Treasury stock, at cost (2014 - 100,276 shares, 2013 - 98,267 shares)	(2,130)	(1,988)
Total stockholders' equity	332,002	321,875
Noncontrolling interest	89	89
Total equity	332,091	321,964
Total liabilities and equity	\$ 3,233,724	\$ 3,175,764

The accompanying notes are an integral part of these consolidated financial statements.

## CONSOLIDATED STATEMENTS OF INCOME (unaudited - in thousands except share and per share data)

	Three Months Ended March 31,	
	2014	2013
<b>NET INTEREST INCOME</b>		
Interest and fees on loans		
Taxable	\$ 25,334	\$ 24,486
Tax exempt	98	102
Interest and dividends on securities		
Taxable	2,011	945
Tax exempt	819	735
Interest on short-term investments	8	24
Total interest income	28,270	26,292
Interest on deposits	3,187	4,637
Interest on borrowings		
Short-term	151	91
Long-term	252	307
Total interest expense	3,590	5,035
<b>NET INTEREST INCOME</b>	<b>24,680</b>	<b>21,257</b>
Provision for loan losses	0	0
<b>NET INTEREST INCOME AFTER PROVISION FOR</b>		
<b>LOAN LOSSES</b>	<b>24,680</b>	<b>21,257</b>
<b>NONINTEREST INCOME</b>		
Wealth advisory fees	1,039	944
Investment brokerage fees	1,117	949
Service charges on deposit accounts	2,151	1,971
Loan, insurance and service fees	1,458	1,456
Merchant card fee income	350	276
Bank owned life insurance income	372	393
Other income	875	982
Mortgage banking income	65	509
Net securities gains	0	1
Total noninterest income	7,427	7,481
<b>NONINTEREST EXPENSE</b>		
Salaries and employee benefits	9,987	9,165
Net occupancy expense	1,110	846
Equipment costs	773	609
Data processing fees and supplies	1,491	1,293
Corporate and business development	416	406

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FDIC insurance and other regulatory fees	477	463
Professional fees	800	595
Other expense	1,736	1,516
Total noninterest expense	16,790	14,893
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	<b>15,317</b>	<b>13,845</b>
Income tax expense	5,405	4,599
<b>NET INCOME</b>	<b>\$ 9,912</b>	<b>\$ 9,246</b>
<b>BASIC WEIGHTED AVERAGE COMMON SHARES</b>	<b>16,513,645</b>	<b>16,408,710</b>
<b>BASIC EARNINGS PER COMMON SHARE</b>	<b>\$ 0.60</b>	<b>\$ 0.56</b>
<b>DILUTED WEIGHTED AVERAGE COMMON SHARES</b>	<b>16,713,853</b>	<b>16,527,171</b>
<b>DILUTED EARNINGS PER COMMON SHARE</b>	<b>\$ 0.59</b>	<b>\$ 0.56</b>

The accompanying notes are an integral part of these consolidated financial statements.



## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited - in thousands)

	Three months ended March 31,	
	2014	2013
Net income	\$ 9,912	\$ 9,246
Other comprehensive income		
Change in securities available for sale:		
Unrealized holding gain (loss) on securities available for sale arising during the period	4,791	(1,040)
Reclassification adjustment for (gains) losses included in net income	0	(1)
Net securities gain (loss) activity during the period	4,791	(1,041)
Tax effect	(1,904)	397
Net of tax amount	2,887	(644)
Defined benefit pension plans:		
Net gain (loss) on defined benefit pension plans	64	(151)
Amortization of net actuarial loss	49	55
Net gain (loss) activity during the period	113	(96)
Tax effect	(52)	39
Net of tax amount	61	(57)
Total other comprehensive income (loss), net of tax	2,948	(701)
Comprehensive income	\$ 12,860	\$ 8,545

The accompanying notes are an integral part of these consolidated financial statements.



CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (unaudited - in thousands except share and per share data)

	Common Stock Shares	Common Stock Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Balance at January 1, 2013	16,290,136	\$ 90,039	\$ 203,654	\$ 5,689	\$ (1,643)	\$ 297,739
Comprehensive income:						
Net income			9,246			9,246
Other comprehensive income (loss), net of tax				(701)		(701)
Treasury shares purchased under deferred directors' plan	(6,466)	173			(173)	0
Treasury stock sold and distributed under deferred directors' plan	3,018	(54)			54	
Stock activity under equity incentive plans	47,234	(138)				(138)
Stock based compensation expense		439				439
Balance at March 31, 2013	16,333,922	\$ 90,459	\$ 212,900	\$ 4,988	\$ (1,762)	\$ 306,585
Balance at January 1, 2014	16,377,449	\$ 93,249	\$ 233,108	\$ (2,494)	\$ (1,988)	\$ 321,875
Comprehensive income:						
Net income			9,912			9,912
Other comprehensive income (loss), net of tax				2,948		2,948

Cash dividends declared, \$0.19 per share			(3,131)					(3,131)
Treasury shares purchased under deferred directors' plan	(5,446)	209			(209)			0
Treasury stock sold and distributed under deferred directors' plan	3,437	(67)			67			0
Stock activity under equity incentive plans	57,901	(199)						(199)
Stock based compensation expense		597						597
Balance at March 31, 2014	16,433,341	\$ 93,789	\$ 239,889	\$	454	\$ (2,130)	\$	332,002

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited - in thousands)

Three Months Ended March 31,	2014	2013
Cash flows from operating activities:		
Net income	\$ 9,912	\$ 9,246
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	830	679
Loss on sale and write down of other real estate owned	1	0
Amortization of intangible assets	0	12
Amortization of loan servicing rights	130	168
Net change in loan servicing rights valuation allowance	0	(37)
Loans originated for sale	(7,035)	(29,409)
Net gain on sales of loans	(192)	(1,021)
Proceeds from sale of loans	6,892	32,949
Net gain on sales and calls of securities available for sale	0	(1)
Net securities amortization	1,490	2,720
Stock based compensation expense	597	439
Earnings on life insurance	(372)	(383)
Tax benefit of stock option exercises	(13)	(14)
Net change:		
Interest receivable and other assets	(299)	(1,005)
Interest payable and other liabilities	2,953	8,765
Total adjustments	4,982	13,862
Net cash from operating activities	14,894	23,108
Cash flows from investing activities:		
Proceeds from maturities, calls and principal paydowns of securities available for sale	14,277	38,293
Purchases of securities available for sale	(13,457)	(57,736)
Purchase of life insurance	(86)	(79)
Loans sold or participated to others	4,836	0
Net increase in total loans	(47,325)	(5,567)
Purchases of land, premises and equipment	(1,070)	(341)
Proceeds from sales of other real estate owned	13	0
Distribution from life insurance	302	0
Net cash from investing activities	(42,510)	(25,430)
Cash flows from financing activities:		
Net increase (decrease) in total deposits	192,706	(130,568)
Net decrease in short-term borrowings	(147,515)	(8,368)
Payments on long-term borrowings	(2)	(15,001)
Common dividends paid	(3,131)	0
Payments related to equity incentive plans	(199)	(138)
Purchase of treasury stock	(209)	(173)
Net cash from financing activities	41,650	(154,248)
Net change in cash and cash equivalents	14,034	(156,570)
Cash and cash equivalents at beginning of the period	63,105	232,237
Cash and cash equivalents at end of the period	\$ 77,139	\$ 75,667

Cash paid during the period for:

Interest	\$	3,570	\$	5,232
Income taxes		465		0
Supplemental non-cash disclosures:				
Loans transferred to other real estate owned		737		0
Securities purchases payable		0		5,216

The accompanying notes are an integral part of these consolidated financial statements.

## NOTE 1. BASIS OF PRESENTATION

This report is filed for Lakeland Financial Corporation (the “Company”) and its wholly owned subsidiaries, Lake City Bank (the “Bank”), and LCB Risk Management, a captive insurance company. All significant inter-company balances and transactions have been eliminated in consolidation. Also included in this report is the Bank’s wholly owned subsidiary, LCB Investments II, Inc. (“LCB Investments”), which manages a portion of the Bank’s investment portfolio. LCB Investments also owns LCB Funding, Inc. (“LCB Funding”), a real estate investment trust.

The unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements and are unaudited. In the opinion of management, all adjustments (all of which are normal and recurring in nature) considered necessary for a fair presentation have been included. Operating results for the three-month period ending March 31, 2014 are not necessarily indicative of the results that may be expected for any subsequent reporting periods, including the year ending December 31, 2014. The 2013 Lakeland Financial Corporation Annual Report on Form 10-K should be read in conjunction with these statements.

## NOTE 2. SECURITIES

Information related to the fair value and amortized cost of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) is provided in the tables below.

(dollars in thousands)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Losses	Fair Value
March 31, 2014				
U.S. Treasury securities	\$ 1,000	\$ 11	\$ 0	\$ 1,011
Agency residential mortgage-backed securities	372,570	6,203	(5,349)	373,424
State and municipal securities	95,121	3,103	(1,210)	97,014
Total	\$ 468,691	\$ 9,317	\$ (6,559)	\$ 471,449
December 31, 2013				
U.S. Treasury securities	\$ 1,001	\$ 16	\$ 0	\$ 1,017
Agency residential mortgage-backed securities	374,611	5,301	(7,935)	371,977
State and municipal securities	95,388	2,597	(2,012)	95,973
Total	\$ 471,000	\$ 7,914	\$ (9,947)	\$ 468,967

There was no other than temporary impairment recognized in accumulated other comprehensive income (loss) for securities available for sale at March 31, 2014 and December 31, 2013.

Information regarding the fair value and amortized cost of available for sale debt securities by maturity as of March 31, 2014 is presented below. Maturity information is based on contractual maturity for all securities other than mortgage-backed securities. Actual maturities of securities may differ from contractual maturities because borrowers may have the right to prepay the obligation without a prepayment penalty.

Amortized                      Fair

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(dollars in thousands)	Cost	Value
Due in one year or less	\$ 4,168	\$ 4,201
Due after one year through five years	17,443	18,468
Due after five years through ten years	43,033	44,208
Due after ten years	31,477	31,148
	96,121	98,025
Mortgage-backed securities	372,570	373,424
Total debt securities	\$ 468,691	\$ 471,449



There were no securities sales during the first three months of 2014 or 2013. All the gains in 2013 were from calls.

Purchase premiums or discounts are recognized in interest income using the interest method over the terms of the securities or over the estimated lives of mortgage-backed securities. Gains and losses on sales are based on the amortized cost of the security sold and recorded on the trade date.

Securities with carrying values of \$238.9 million and \$192.4 million were pledged as of March 31, 2014 and 2013, as collateral for deposits of public funds, securities sold under agreements to repurchase, borrowings from the Federal Home Loan Bank and for other purposes as permitted or required by law.

Information regarding securities with unrealized losses as of March 31, 2014 and December 31, 2013 is presented below. The tables divide the securities between those with unrealized losses for less than twelve months and those with unrealized losses for twelve months or more.

(dollars in thousands)	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2014						
Agency residential mortgage-backed securities	\$ 147,322	\$ (3,847)	\$ 27,140	\$ (1,502)	\$ 174,462	\$ (5,349)
State and municipal securities	13,167	(432)	10,695	(778)	23,862	(1,210)
Total temporarily impaired	\$ 160,489	\$ (4,279)	\$ 37,835	\$ (2,280)	\$ 198,324	\$ (6,559)
December 31, 2013						
Agency residential mortgage-backed securities	\$ 177,779	\$ (6,444)	\$ 34,093	\$ (1,491)	\$ 211,872	\$ (7,935)
State and municipal securities	24,610	(1,102)	8,037	(910)	32,647	(2,012)
Total temporarily impaired	\$ 202,389	\$ (7,546)	\$ 42,130	\$ (2,401)	\$ 244,519	\$ (9,947)

The total number of securities with unrealized losses as of March 31, 2014 and December 31, 2013 is presented below.

	Less than 12 months	12 months or more	Total
March 31, 2014			
Agency residential mortgage-backed securities	43	8	51
State and municipal securities	34	18	52
Total temporarily impaired	77	26	103
December 31, 2013			
Agency residential mortgage-backed securities	49	10	59

State and municipal securities	59	12	71
Total temporarily impaired	108	22	130

The following factors are considered in determining whether or not the impairment of these securities is other-than-temporary. In making this determination, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) other-than-temporary impairment (OTTI) related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. Credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings. Ninety-nine percent of the securities are backed by the U.S. government, government agencies, government sponsored agencies or are A-rated or better, except for certain non-local or local municipal securities, which are not rated. For the government, government-sponsored agency and municipal securities, management did not have concerns of credit losses and there was nothing to indicate that full principal would not be received. Management considered the unrealized losses on these securities to be primarily interest rate driven and does not expect material losses given current market conditions unless the securities are sold. However, at this time management does not have the intent to sell, and it is more likely than not that it will not be required to sell these securities before the recovery of their amortized cost basis.

## NOTE 3. LOANS

(dollars in thousands)	March 31, 2014			December 31, 2013		
Commercial and industrial loans:						
Working capital lines of credit loans	\$ 476,818	18.5	%	\$ 457,690	18.0	%
Non-working capital loans	467,679	18.2		443,877	17.5	
Total commercial and industrial loans	944,497	36.7		901,567	35.6	
Commercial real estate and multi-family residential loans:						
Construction and land development loans	144,978	5.6		157,630	6.2	
Owner occupied loans	388,052	15.1		370,386	14.6	
Nonowner occupied loans	424,143	16.5		394,748	15.6	
Multifamily loans	57,882	2.2		63,443	2.5	
Total commercial real estate and multi-family residential loans	1,015,055	39.4		986,207	38.9	
Agri-business and agricultural loans:						
Loans secured by farmland	109,260	4.2		133,458	5.3	
Loans for agricultural production	104,384	4.1		120,571	4.8	
Total agri-business and agricultural loans	213,644	8.3		254,029	10.0	
Other commercial loans	77,324	3.0		70,770	2.8	
Total commercial loans	2,250,520	87.4		2,212,573	87.3	
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	135,111	5.3		125,444	4.9	
Open end and junior lien loans	139,185	5.4		146,946	5.8	
Residential construction and land development loans	5,658	0.2		4,640	0.2	
Total consumer 1-4 family mortgage loans	279,954	10.9		277,030	10.9	
Other consumer loans	44,319	1.7		46,125	1.8	
Total consumer loans	324,273	12.6		323,155	12.7	
Subtotal	2,574,793	100.0	%	2,535,728	100.0	%
Less: Allowance for loan losses	(46,137)			(48,797)		
Net deferred loan fees	(603)			(630)		
Loans, net	\$ 2,528,053			\$ 2,486,301		

## NOTE 4. ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The following tables present the activity in the allowance for loan losses by portfolio segment for the three-month periods ended March 31, 2014 and 2013:

	Commercial and Industrial	Commercial Real Estate and Multifamily Residential	Agri-business and Agricultural	Other Commercial	Consumer 1-4 Family Mortgage	Other Consumer	Unallocated	Total
(dollars in thousands) March 31, 2014								
Beginning balance	\$ 21,005	\$ 18,556	\$ 1,682	\$ 391	\$ 3,046	\$ 608	\$ 3,509	\$ 48,797
Provision for loan losses	720	(388)	(279)	(142)	132	(23)	(20)	0
Loans charged-off	(30)	(2,531)	0	0	(115)	(75)	0	(2,751)
Recoveries	35	11	5	0	1	39	0	91
Net loans charged-off	5	(2,520)	5	0	(114)	(36)	0	(2,660)
Ending balance	\$ 21,730	\$ 15,648	\$ 1,408	\$ 249	\$ 3,064	\$ 549	\$ 3,489	\$ 46,137

	Commercial and Industrial	Commercial Real Estate and Multifamily Residential	Agri-business and Agricultural	Other Commercial	Consumer 1-4 Family Mortgage	Other Consumer	Unallocated	Total
(dollars in thousands) March 31, 2013								
Beginning balance	\$ 22,342	\$ 20,812	\$ 1,403	\$ 240	\$ 2,682	\$ 609	\$ 3,357	\$ 51,445
Provision for loan losses	(359)	253	(142)	(17)	270	(23)	18	0
Loans charged-off	(133)	(906)	0	0	(108)	(59)	0	(1,206)
Recoveries	263	261	2	0	22	31	0	579
Net loans charged-off	130	(645)	2	0	(86)	(28)	0	(627)
Ending balance	\$ 22,113	\$ 20,420	\$ 1,263	\$ 223	\$ 2,866	\$ 558	\$ 3,375	\$ 50,818



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

	Commercial and Industrial	Commercial Real Estate and Multifamily Residential	Agri-business and Agricultural	Other Commercial	Consumer 1-4 Family Mortgage	Other Consumer	Unallocated	Total
(dollars in thousands)								
March 31, 2014								
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 3,521	\$ 2,002	\$ 26	\$ 0	\$ 500	\$ 33	\$ 0	\$ 6,082
Collectively evaluated for impairment	18,209	13,646	1,382	249	2,564	516	3,489	40,055
Total ending allowance balance	\$ 21,730	\$ 15,648	\$ 1,408	\$ 249	\$ 3,064	\$ 549	\$ 3,489	\$ 46,137
Loans:								
Loans individually evaluated for impairment	\$ 16,458	\$ 12,753	\$ 875	\$ 0	\$ 3,934	\$ 91	\$ 0	\$ 34,111
Loans collectively evaluated for impairment	928,325	1,000,956	212,865	77,322	276,429	44,182	0	2,540,079
Total ending loans balance	\$ 944,783	\$ 1,013,709	\$ 213,740	\$ 77,322	\$ 280,363	\$ 44,273	\$ 0	\$ 2,574,190

	Commercial and Industrial	Commercial Real Estate and Multifamily Residential	Agri-business and Agricultural	Other Commercial	Consumer 1-4 Family Mortgage	Other Consumer	Unallocated	Total
(dollars in thousands)								

December 31,  
2013

Allowance for  
loan losses:

Ending  
allowance  
balance  
attributable to  
loans:

Individually evaluated for impairment	\$ 4,144	\$ 4,598	\$ 38	\$ 0	\$ 479	\$ 57	\$ 0	\$ 9,316
Collectively evaluated for impairment	16,861	13,959	1,644	391	2,566	551	3,509	39,481
Total ending allowance balance	\$ 21,005	\$ 18,557	\$ 1,682	\$ 391	\$ 3,045	\$ 608	\$ 3,509	\$ 48,797

Loans:

Loans individually evaluated for impairment	\$ 16,196	\$ 22,204	\$ 1,114	\$ 0	\$ 3,594	\$ 119	\$ 0	\$ 43,227
Loans collectively evaluated for impairment	885,651	962,673	253,011	70,766	273,812	45,958	0	2,491,871
Total ending loans balance	\$ 901,847	\$ 984,877	\$ 254,125	\$ 70,766	\$ 277,406	\$ 46,077	\$ 0	\$ 2,535,098

The recorded investment in loans does not include accrued interest.

The following table presents loans individually evaluated for impairment by class of loans as of March 31, 2014:

(dollars in thousands)	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 112	\$ 111	\$ 0
Commercial real estate and multi-family residential loans:			
Owner occupied loans	505	285	0
Nonowner occupied loans	352	352	0
Agri-business and agricultural loans:			
Loans secured by farmland	381	382	0
Consumer 1-4 family loans:			
Closed end first mortgage loans	688	689	0
Open end and junior lien loans	74	74	0
Residential construction loans	144	145	0
Other consumer loans	1	1	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	2,015	2,014	640
Non-working capital loans	17,890	14,333	2,881
Commercial real estate and multi-family residential loans:			
Construction and land development loans	2,665	2,664	726
Owner occupied loans	2,127	2,105	448
Nonowner occupied loans	7,979	7,347	828
Agri-business and agricultural loans:			
Loans secured by farmland	992	493	26
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	3,057	2,926	497
Open end and junior lien loans	101	100	3
Other consumer loans	90	90	33
Total	\$ 39,173	\$ 34,111	\$ 6,082

The recorded investment in loans does not include accrued interest.





The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2013:

(dollars in thousands)	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 63	\$ 63	\$ 0
Commercial real estate and multi-family residential loans:			
Owner occupied loans	377	196	0
Agri-business and agricultural loans:			
Loans secured by farmland	604	604	0
Other commercial loans			
Consumer 1-4 family loans:			
Closed end first mortgage loans	688	689	0
Open end and junior lien loans	81	81	0
Residential construction loans	150	150	0
Other consumer loans	1	1	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	5,251	2,641	984
Non-working capital loans	15,345	13,492	3,160
Commercial real estate and multi-family residential loans:			
Construction and land development loans	2,795	2,795	585
Owner occupied loans	5,553	4,681	723
Nonowner occupied loans	15,163	14,532	3,290
Agri-business and agricultural loans:			
Loans secured by farmland	1,008	510	38
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	3,469	2,463	442
Open end and junior lien loans	211	211	37
Other consumer loans	118	118	57
<b>Total</b>	<b>\$ 50,877</b>	<b>\$ 43,227</b>	<b>\$ 9,316</b>

The recorded investment in loans does not include accrued interest.



The following table presents loans individually evaluated for impairment by class of loans as of March 31, 2014:

(dollars in thousands)	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Income Recognized
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 112	\$ 1	\$ 0
Commercial real estate and multi-family residential loans:			
Owner occupied loans	318	0	0
Nonowner occupied loans	355	0	0
Agri-business and agricultural loans:			
Loans secured by farmland	393	0	0
Consumer 1-4 family loans:			
Closed end first mortgage loans	689	0	0
Open end and junior lien loans	68	0	0
Residential construction loans	147	0	0
Other consumer loans	1	0	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	2,450	12	13
Non-working capital loans	13,783	126	126
Commercial real estate and multi-family residential loans:			
Construction and land development loans	2,631	15	15
Owner occupied loans	3,710	13	14
Nonowner occupied loans	11,834	34	34
Agri-business and agricultural loans:			
Loans secured by farmland	501	0	0
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	2,933	16	19
Open end and junior lien loans	117	0	0
Other consumer loans	92	0	0
Total	\$ 40,134	\$ 217	\$ 221

The recorded investment in loans does not include accrued interest.



The following table presents loans individually evaluated for impairment by class of loans as of March 31, 2013:

(dollars in thousands)	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Income Recognized
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 65	\$ 0	\$ 0
Non-working capital loans	34	0	0
Commercial real estate and multi-family residential loans:			
Owner occupied loans	566	0	0
Agri-business and agricultural loans:			
Loans secured by farmland	521	0	0
Consumer 1-4 family loans:			
Closed end first mortgage loans	58	0	0
Open end and junior lien loans	41	0	0
Other consumer loans	1	0	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	3,170	13	13
Non-working capital loans	14,412	135	137
Commercial real estate and multi-family residential loans:			
Construction and land development loans	4,528	45	52
Owner occupied loans	4,300	29	31
Nonowner occupied loans	24,299	84	87
Agri-business and agricultural loans:			
Loans secured by farmland	327	0	0
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	2,499	0	19
Open end and junior lien loans	40	0	0
Other consumer loans	80	0	0
<b>Total</b>	<b>\$ 55,132</b>	<b>\$ 306</b>	<b>\$ 339</b>

The recorded investment in loans does not include accrued interest.



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The following table presents the aging of the recorded investment in past due loans as of March 31, 2014 by class of loans:

(dollars in thousands)	Loans Not Past Due	30-89 Days Past Due	Greater than 90 Days Past Due	Nonaccrual	Total Past Due	Total
Commercial and industrial loans:						
Working capital lines of credit loans	\$ 476,355	\$ 375	\$ 0	\$ 343	\$ 718	\$ 477,073
Non-working capital loans	463,387	9	0	4,314	4,323	467,710
Commercial real estate and multi-family residential loans:						
Construction and land development loans	143,993	0	0	535	535	144,528
Owner occupied loans	385,623	0	0	2,128	2,128	387,751
Nonowner occupied loans	418,671	0	0	4,946	4,946	423,617
Multifamily loans	57,813	0	0	0	0	57,813
Agri-business and agricultural loans:						
Loans secured by farmland	108,394	0	0	874	874	109,268
Loans for agricultural production	104,472	0	0	0	0	104,472
Other commercial loans	77,322	0	0	0	0	77,322
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	132,071	1,205	21	1,545	2,771	134,842
Open end and junior lien loans	139,570	127	0	175	302	139,872
Residential construction loans	5,504	0	0	145	145	5,649
Other consumer loans	44,103	92	0	78	170	44,273
<b>Total</b>	<b>\$ 2,557,278</b>	<b>\$ 1,808</b>	<b>\$ 21</b>	<b>\$ 15,083</b>	<b>\$ 16,912</b>	<b>\$ 2,574,190</b>

The recorded investment in loans does not include accrued interest.

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

(dollars in thousands)	Loans Not Past Due	30-89 Days Past Due	Greater than 90 Days Past Due	Nonaccrual	Total Past Due	Total
Commercial and industrial loans:						
Working capital lines of credit loans	\$ 456,136	\$ 0	\$ 0	\$ 1,819	\$ 1,819	\$ 457,955
Non-working capital loans	440,050	46	0	3,796	3,842	443,892
Commercial real estate and multi-family residential loans:						



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Construction and land development loans	156,594	0	0	544	544	157,138
Owner occupied loans	366,955	0	0	3,156	3,156	370,111
Nonowner occupied loans	382,478	0	0	11,758	11,758	394,236
Multifamily loans	63,392	0	0	0	0	63,392
Agri-business and agricultural loans:						
Loans secured by farmland	132,347	0	0	1,113	1,113	133,460
Loans for agricultural production	120,665	0	0	0	0	120,665
Other commercial loans	70,766	0	0	0	0	70,766
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	122,370	1,645	0	1,165	2,810	125,180
Open end and junior lien loans	147,123	135	46	291	472	147,595
Residential construction loans	4,481	0	0	150	150	4,631
Other consumer loans	45,826	145	0	106	251	46,077
Total	\$ 2,509,183	\$ 1,971	\$ 46	\$ 23,898	\$ 25,915	\$ 2,535,098

The recorded investment in loans does not include accrued interest.

## Troubled Debt Restructurings:

Troubled debt restructured loans are included in the totals for impaired loans. The Company has allocated \$4.8 million and \$8.3 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of March 31, 2014 and December 31, 2013. The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring.

(dollars in thousands)	March 31, 2014	December 31, 2013
Accruing troubled debt restructured loans	\$ 16,222	\$ 17,714
Nonaccrual troubled debt restructured loans	10,721	18,531
Total troubled debt restructured loans	\$ 26,943	\$ 36,245

During the quarter ending March 31, 2014, certain loans were modified as troubled debt restructurings. The modified terms of these loans include one or a combination of the following: inadequate compensation for the terms of the restructure or renewal; a modification of the repayment terms which delays principal repayment for some period; or renewal terms offered to borrowers in financial distress where no additional credit enhancements were obtained at the time of renewal.

During the quarter ending March 31, 2014, there were restructured terms offered to one borrower under financial duress which did not require additional compensation or consideration, and the terms offered would not have been readily available in the marketplace for loans bearing similar risk profiles. In this instance, it was determined that a concession had been granted. It is difficult to quantify the concession granted due to an absence of readily available market terms to be used for comparison. The restructure was granted to a borrower engaged in retail sales where the collateral and cash flow did not support the loan with a recorded investment of \$159,000.

An additional concession was granted to a borrower with a previously restructured loan. The new concession includes further forgiveness of principal if the terms of the restructured loan are met during the life of the loan. This borrower had a recorded investment of \$2.7 million as of March 31, 2014, which is not included in the table below since it was not considered a new troubled debt restructuring.

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ending March 31, 2014:

	Number of Loans	All Modifications		Modified Repayment Terms	
		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Extension Period or Range (in months)
(dollars in thousands)					
Troubled Debt Restructurings					
Commercial and industrial loans:					
Non-working capital loans	2	\$ 433	\$ 433	2	12-15

Commercial real estate and multi-

family residential loans:						
Owner occupied loans	1		158		159	
Total	3	\$	591	\$	592	2 12-15

For the period ending March 31, 2014, the commercial and industrial troubled debt restructurings described above increased the allowance for loan losses by \$101,000 and the commercial real estate and multi-family residential loan troubled debt restructuring in the chart above decreased the allowance for loan losses by \$6,000.

No charge-offs resulted from any of the troubled debt restructurings described above during the period ending March 31, 2014.

During the quarter ending March 31, 2013, loans totaling \$1.8 million were modified as troubled debt restructurings. The modified terms of the loans included reductions in the interest rates to rates that would not be readily available in the marketplace for borrowers with a similar risk profile and modifications of the repayment terms. These restructured loans were provided to related borrowers who are engaged in land development.

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ending March 31, 2013:

	Number of Loans	All Modifications		Interest Rate Reductions		
		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Interest at Pre-Modification Rate	Interest at Post-Modification Rate
(dollars in thousands) Troubled Debt Restructurings Commercial real estate and multi-family residential loans: Construction and land development loans	6	\$ 2,198	\$ 2,198	6	\$ 85	\$ 63
Total	6	\$ 2,198	\$ 2,198	6	\$ 85	\$ 63

For the three month period ending March 31, 2013 the commercial real estate and multi-family residential loan troubled debt restructuring described above decreased the allowance for loan losses by \$287,000.

There were no troubled debt restructurings which had payment defaults within the twelve months following modification during the three months ended March 31, 2014. The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification which occurred during the three month period ending March 31, 2013:

	2013 Number of Loans	Recorded Investment
(dollars in thousands) Troubled Debt Restructurings that Subsequently Defaulted Commercial real estate and multi-family residential loans: Construction and land development loans	1	\$ 1,249
Total	1	\$ 1,249

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

The troubled debt restructurings described above that subsequently defaulted increased the allowance for loan losses by \$15,000 and did not result in any charge offs during the three month period ending March 31, 2013.

During the first quarter of 2014 the Company sold, to an independent party, three loans totaling \$6.7 million, representing a single commercial relationship. The three loans were accounted for as troubled debt restructurings. The Company received proceeds of \$4.3 million and recognized charge offs of \$2.4 million as a result of the sale. The amount charged-off had previously been reserved for by the Company.

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 analyzes commercial loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for Special Mention, Substandard and Doubtful grade loans and annually on Pass grade loans over \$250,000.

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 Company 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 characteristics 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 with the exception of consumer troubled debt restructurings which are evaluated and listed with Substandard commercial grade loans and consumer nonaccrual loans which are evaluated individually and listed with Not Rated loans. Loans listed as not rated are consumer loans included in groups of homogenous loans which are analyzed for credit quality indicators utilizing delinquency status. As of March 31, 2014, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

(dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Not Rated	Total
Commercial and industrial loans:						
Working capital lines of credit loans	\$ 444,957	\$ 20,467	\$ 11,649	\$ 0	\$ 0	\$ 477,073
Non-working capital loans	407,143	38,211	20,057	0	2,299	467,710
Commercial real estate and multi-family residential loans:						
Construction and land development loans	135,860	690	7,978	0	0	144,528
Owner occupied loans	349,274	27,068	11,409	0	0	387,751
Nonowner occupied loans	403,435	9,104	11,078	0	0	423,617
Multifamily loans	57,813	0	0	0	0	57,813
Agri-business and agricultural loans:						
Loans secured by farmland	108,166	0	1,086	0	16	109,268
Loans for agricultural production	104,472	0	0	0	0	104,472
Other commercial loans	77,318	0	0	0	4	77,322
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	33,291	0	2,298	0	99,253	134,842
Open end and junior lien loans	9,173	1,862	0	0	128,837	139,872
Residential construction loans	0	0	0	0	5,649	5,649
Other consumer loans	10,041	405	291	0	33,536	44,273
Total	\$ 2,140,943	\$ 97,807	\$ 65,846	\$ 0	\$ 269,594	\$ 2,574,190

The recorded investment in loans does not include accrued interest.

As of December 31, 2013, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

(dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Not Rated	Total
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## Commercial and industrial loans:

Working capital lines of credit loans	\$ 431,069	\$ 15,212	\$ 11,674	\$ 0	\$ 0	\$ 457,955
Non-working capital loans	384,415	37,727	19,659	0	2,091	443,892
Commercial real estate and multi-family residential loans:						
Construction and land development loans	148,338	763	8,037	0	0	157,138
Owner occupied loans	333,795	23,687	12,629	0	0	370,111
Nonowner occupied loans	367,108	9,180	17,948	0	0	394,236
Multifamily loans	63,392	0	0	0	0	63,392
Agri-business and agricultural loans:						
Loans secured by farmland	132,331	0	1,113	0	16	133,460
Loans for agricultural production	120,665	0	0	0	0	120,665
Other commercial loans	70,766	0	0	0	0	70,766
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	29,092	0	2,316	0	93,772	125,180
Open end and junior lien loans	8,291	1,863	0	0	137,441	147,595
Residential construction loans	0	0	0	0	4,631	4,631
Other consumer loans	10,722	416	291	0	34,648	46,077
Total	\$ 2,099,984	\$ 88,848	\$ 73,667	\$ 0	\$ 272,599	\$ 2,535,098

The recorded investment in loans does not include accrued interest.



## NOTE 5. FAIR VALUE DISCLOSURES

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 company'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:

**Securities:** Securities available for sale are valued primarily by a third party pricing service. The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or pricing models which utilize significant observable inputs such as matrix pricing. This is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). These models utilize the market approach with standard inputs that include, but are not limited to, benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data. For certain non-agency residential mortgage-backed securities where observable inputs about the specific issuer are not available, fair values are estimated using observable data from other non-agency residential mortgage-backed securities presumed to be similar or other market data on other non-agency residential mortgage-backed securities (Level 3 inputs). For certain municipal securities that are not rated and observable inputs about the specific issuer are not available, fair values are estimated using observable data from other municipal securities presumed to be similar or other market data on other non-rated municipal securities (Level 3 inputs).

The Company's Controlling Department, which is responsible for all accounting and SEC compliance, and the Company's Treasury Department, which is responsible for investment portfolio management and asset/liability modeling, are the two areas that determine the Company's valuation policies and procedures. Both of these areas report directly to the Executive Vice President and Chief Financial Officer of the Company. For assets or liabilities that may be considered for Level 3 fair value measurement on a recurring basis, these two departments and the Executive Vice President and Chief Financial Officer determine the appropriate level of the assets or liabilities under consideration. If there are assets or liabilities that are determined to be Level 3 by this group, the Risk Management Committee of the Company and the Audit Committee of the Board of Directors are made aware of such assets at their next scheduled meeting.

Securities pricing is obtained from a third party pricing service and is tested at least annually against prices from another third party provider and reviewed with a market value price tolerance variance of +/-3%, an individual security market value tolerance of +/- \$50,000 and an aggregate market value tolerance of +/- \$500,000 for all securities. If any securities fall outside any of these tolerance thresholds, they are reviewed in more detail to determine why the variance exists. Changes in market value are reviewed monthly in aggregate yield by security type and any material differences are reviewed to determine why they exist. At least annually, the pricing methodology of the pricing service is received and reviewed to support the fair value levels used by the Company. A detailed pricing evaluation is requested and reviewed on any security determined to be fair valued using unobservable inputs by the pricing service.

Mortgage banking derivatives: The fair value of mortgage banking derivatives are based on observable market data as of the measurement date (Level 2).

Interest rate swap derivatives: The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Currently, none of the Company's derivatives are designated in qualifying hedging relationships, as the derivatives are not used to manage risks within the Company's assets or liabilities. As such, all changes in fair value of the Company's derivatives are recognized directly in earnings. The fair value of interest rate swap derivatives is determined by pricing or valuation models using observable market data as of the measurement date (Level 2).

**Impaired loans:** Impaired loans with specific allocations of the allowance for loan losses are generally based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Fair value is determined using several methods. Generally, the fair value of real estate is based on appraisals by qualified third party appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and result in a Level 3 classification of the inputs for determining fair value. In addition, the Company's management routinely applies internal discount factors to the value of appraisals used in the fair value evaluation of impaired loans. The deductions to the appraisals take into account changing business factors and market conditions, as well as value impairment in cases where the appraisal date predates a likely change in market conditions. Commercial real estate is generally discounted from its appraised value by 0-50% with the higher discounts applied to real estate that is determined to have a thin trading market or to be specialized collateral. In addition to real estate, the Company's management evaluates other types of collateral as follows: (a) raw and finished inventory is discounted from its cost or book value by 35-65%, depending on the marketability of the goods; (b) finished goods are generally discounted by 30-60%, depending on the ease of marketability, cost of transportation or scope of use of the finished good; (c) work in process inventory is typically discounted by 50-100%, depending on the length of manufacturing time, types of components used in the completion process, and the breadth of the user base; (d) equipment is valued at a percentage of depreciated book value or recent appraised value, if available, and is typically discounted at 30-70% after various considerations including age and condition of the equipment, marketability, breadth of use, and whether the equipment includes unique components or add-ons; and (e) Marketable securities are discounted by 10-30%, depending on the type of investment, age of valuation report and general market conditions. This methodology is based on a market approach and typically results in a Level 3 classification of the inputs for determining fair value.

**Mortgage servicing rights:** As of March 31, 2014 the fair value of the Company's Level 3 servicing assets for residential mortgage loans was \$3.2 million, none of which are currently impaired and therefore carried at amortized cost. These residential mortgage loans have a weighted average interest rate of 4.10%, a weighted average maturity of 19 years and are secured by homes generally within the Company's market area, which is primarily Northern Indiana. A valuation model is used to estimate fair value, which is based on an income approach. The inputs used include estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income. The most significant assumption used to value mortgage servicing rights is prepayment rate. Prepayment rates are estimated based on published industry consensus prepayment rates. The most significant unobservable assumption is the discount rate. At March 31, 2014, the constant prepayment speed (PSA) used was 189 and the discount rate used was 9.4%. At December 31, 2013, the PSA used was 185 and the discount rate used was 9.4%.

**Other real estate owned:** Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned 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 and are reviewed by the Company's internal appraisal officer. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales. Such adjustments are usually significant and result in a Level 3 classification. In addition, the Company's management may apply discount factors to the appraisals to take into account changing business factors and market conditions, as well as value impairment in cases where the appraisal date predates a likely change in market conditions. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

**Real estate mortgage loans held for sale:** Real estate mortgage loans held for sale are carried at the lower of cost or fair value, as determined by outstanding commitments, from third party investors, and result in a Level 2 classification.



The table below presents the balances of assets measured at fair value on a recurring basis:

(dollars in thousands)	March 31, 2014			Assets at Fair Value
	Level 1	Level 2	Level 3	
<b>Assets</b>				
U.S. Treasury securities	\$ 1,011	\$ 0	\$ 0	\$ 1,011
Mortgage-backed securities	0	373,424	0	373,424
State and municipal securities	0	96,123	891	97,014
Total securities	1,011	469,547	891	471,449
Mortgage banking derivative	0	144	0	144
Interest rate swap derivative	0	640	0	640
Total assets	\$ 1,011	\$ 470,331	\$ 891	\$ 472,233
<b>Liabilities</b>				
Mortgage banking derivative	0	1	0	1
Interest rate swap derivative	0	629	0	629
Total liabilities	\$ 0	\$ 630	\$ 0	\$ 630

(dollars in thousands)	December 31, 2013			Assets at Fair Value
	Level 1	Level 2	Level 3	
<b>Assets</b>				
U.S. Treasury securities	\$ 1,017	\$ 0	\$ 0	\$ 1,017
Mortgage-backed securities	0	371,977	0	371,977
State and municipal securities	0	94,998	975	95,973
Total securities	1,017	466,975	975	468,967
Mortgage banking derivative	0	142	0	142
Interest rate swap derivative	0	627	0	627
Total assets	\$ 1,017	\$ 467,744	\$ 975	\$ 469,736
<b>Liabilities</b>				
Mortgage banking derivative	0	2	0	2
Interest rate swap derivative	0	592	0	592
Total liabilities	\$ 0	\$ 594	\$ 0	\$ 594

There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2014 and there were no transfers between Level 1 and Level 2 during 2013.

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2014 and 2013:

(dollars in thousands)	Non-Agency Residential Mortgage-Backed Securities		State and Municipal Securities	
	2014	2013	2014	2013
Balance of recurring Level 3 assets at January 1	\$ 0	\$ 2,859	\$ 975	\$ 988
Transfers into Level 3	0	3,334	0	0

Changes in fair value of securities	0	(17)	1	(2)
Principal payments	0	(291)	(85)	0
Balance of recurring Level 3 assets at				
March 31	\$ 0	\$ 5,885	\$ 891	\$ 986

The fair value of two non-agency residential mortgage-backed securities with a fair value of \$3.3 million as of March 31, 2013 were transferred out of Level 2 and into Level 3 because of a lack of observable market data for these investments. The Company's policy is to recognize transfers as of the end of the reporting period. As a result, the fair value for these non-agency residential mortgage-backed securities and state and municipal securities was transferred into Level 3 on March 31, 2013. The securities were subsequently sold in the third quarter of 2013. The Company no longer owns any non-agency residential mortgage backed securities.

The state and municipal securities measured at fair value included below are non-rated Indiana municipal revenue bonds and are not actively traded.

Quantitative Information about Level 3 Fair Value Measurements

(dollars in thousands)	Fair Value at 3/31/2014	Valuation Technique	Unobservable Input	Range of Inputs (Average)
State and municipal securities	\$ 891	Price to type, par, call	Discount to benchmark index	0-6% (2.43%)

Quantitative Information about Level 3 Fair Value Measurements

(dollars in thousands)	Fair Value at 12/31/2013	Valuation Technique	Unobservable Input	Range of Inputs (Average)
State and municipal securities	\$ 975	Price to type, par, call	Discount to benchmark index	0-6% (2.21%)

The primary methodology used in the fair value measurement of the Company's state and municipal securities classified as Level 3 is a discount to the AAA municipal benchmark index. Significant increases or (decreases) in this index as well as the degree to which the security differs in ratings, coupon, call and duration will result in a higher or (lower) fair value measurement for those securities that are not callable. For those securities that are continuously callable, a slight premium to par is used.





The table below presents the balances of assets measured at fair value on a nonrecurring basis:

(dollars in thousands)	March 31, 2014			Assets at Fair Value
	Level 1	Level 2	Level 3	
Assets				
Impaired loans:				
Commercial and industrial loans:				
Working capital lines of credit loans	\$ 0	\$ 0	\$ 1,374	\$ 1,374
Non-working capital loans	0	0	3,281	3,281
Commercial real estate and multi-family residential loans:				
Construction and land development loans	0	0	1,938	1,938
Owner occupied loans	0	0	1,657	1,657
Nonowner occupied loans	0	0	4,217	4,217
Agri-business and agricultural loans:				
Loans secured by farmland	0	0	467	467
Consumer 1-4 family mortgage loans:				
Closed end first mortgage loans	0	0	824	824
Open end and junior lien loans	0	0	98	98
Other consumer loans	0	0	46	46
Total impaired loans	\$ 0	\$ 0	\$ 13,902	\$ 13,902
Other real estate owned	0	0	75	75
Total assets	\$ 0	\$ 0	\$ 13,977	\$ 13,977

(dollars in thousands)	December 31, 2013			Assets at Fair Value
	Level 1	Level 2	Level 3	
Assets				
Impaired loans:				
Commercial and industrial loans:				
Working capital lines of credit loans	\$ 0	\$ 0	\$ 920	\$ 920
Non-working capital loans	0	0	3,097	3,097
Commercial real estate and multi-family residential loans:				
Construction and land development loans	0	0	2,210	2,210
Owner occupied loans	0	0	3,958	3,958
Nonowner occupied loans	0	0	8,938	8,938
Agri-business and agricultural loans:				
Loans secured by farmland	0	0	472	472
Consumer 1-4 family mortgage loans:				
Closed end first mortgage loans	0	0	409	409

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Open end and junior lien loans	0	0	174	174
Other consumer loans	0	0	50	50
Total impaired loans	\$ 0	\$ 0	\$ 20,228	\$ 20,228
Other real estate owned	0	0	75	75
Total assets	\$ 0	\$ 0	\$ 20,303	\$ 20,303

The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at March 31, 2014:

(dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Average	Range of Inputs
Impaired loans:					
Commercial and industrial	\$ 4,655	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	34%	(2% - 43%)
Impaired loans:					
Commercial real estate	7,812	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	17%	(2% - 39%)
Impaired loans:					
Agri-business and agricultural	467	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	5%	(2% - 9%)
Impaired loans:					
Consumer 1-4 family mortgage	922	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	21%	(3% - 77%)
Impaired loans:					
Other consumer	46	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	40%	(30% - 47%)
Other real estate owned	75	Appraisals	Discount to reflect current market conditions	49%	

The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at December 31, 2013:

(dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Average	Range of Inputs
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## Impaired loans:

Commercial and industrial	\$ 4,017	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	29%	(3% - 93%)
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## Impaired loans:

Commercial real estate	15,106	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	22%	(3% - 45%)
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## Impaired loans:

Agri-business and agricultural	472	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	8%	(4% - 12%)
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## Impaired loans:

Consumer 1-4 family mortgage	583	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	33%	(6% - 77%)
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## Impaired loans:

Other consumer	50	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	53%	(28% - 98%)
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Other real estate owned	75	Appraisals	Discount to reflect current market conditions and ultimate collectability	49%	
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Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a gross carrying amount of \$18.1 million, with a valuation allowance of \$4.2 million at March 31, 2014, resulting in a net recovery in the provision for loan losses of \$2.1 million in the three months ended March 31, 2014. At March 31, 2013, impaired loans had a gross carrying amount of \$29.9 million, with a valuation allowance of \$7.7 million, resulting in a net recovery in the provision for loan losses of \$2.3 million for the three months ended March 31, 2013.

The following table contains the estimated fair values and the related carrying values of the Company's financial instruments. Items which are not financial instruments are not included.

(dollars in thousands)	Carrying Value	March 31, 2014			Total
		Level 1	Level 2	Level 3	
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 77,139	\$ 77,139	\$ 0	\$ 0	\$ 77,139
Securities available for sale	471,449	1,011	469,547	891	471,449
Real estate mortgages held for sale	2,043	0	2,067	0	2,067
Loans, net	2,528,053	0	0	2,526,033	2,526,033
Federal Home Loan Bank stock	7,312	N/A	N/A	N/A	N/A
Federal Reserve Bank stock	3,420	N/A	N/A	N/A	N/A
Accrued interest receivable	8,833	0	2,006	6,827	8,833
<b>Financial Liabilities:</b>					
Certificates of deposit	(899,727)	0	(907,835)	0	(907,835)
All other deposits	(1,839,047)	(1,839,047)	0	0	(1,839,047)
Securities sold under agreements					
to repurchase	(81,361)	0	(81,361)	0	(81,361)
Federal funds purchased	(8,000)	0	(8,000)	0	(8,000)
Other short-term borrowings	(25,000)	0	(24,998)	0	(24,998)
Long-term borrowings	(35)	0	(41)	0	(41)
Subordinated debentures	(30,928)	0	0	(31,226)	(31,226)
Standby letters of credit	(348)	0	0	(348)	(348)
Accrued interest payable	(2,938)	(115)	(2,820)	(3)	(2,938)

(dollars in thousands)	Carrying Value	December 31, 2013			Total
		Level 1	Level 2	Level 3	
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 63,105	\$ 63,105	\$ 0	\$ 0	\$ 63,105
Securities available for sale	468,967	1,017	466,975	975	468,967
Real estate mortgages held for sale	1,778	0	1,800	0	1,800
Loans, net	2,486,301	0	0	2,490,593	2,490,593
Federal Home Loan Bank stock	7,312	N/A	N/A	N/A	N/A
Federal Reserve Bank stock	3,420	N/A	N/A	N/A	N/A
Accrued interest receivable	8,577	0	2,297	6,280	8,577
<b>Financial Liabilities:</b>					
Certificates of deposit	(727,809)	0	(736,088)	0	(736,088)

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All other deposits	(1,818,259)	(1,818,259)	0	0	(1,818,259)
Securities sold under agreements					
to repurchase	(104,876)	0	(104,876)	0	(104,876)
Federal funds purchased	(11,000)	0	(11,000)	0	(11,000)
Other short-term borrowings	(146,000)	0	(146,002)	0	(146,002)
Long-term borrowings	(37)	0	(43)	0	(43)
Subordinated debentures	(30,928)	0	0	(31,217)	(31,217)
Standby letters of credit	(312)	0	0	(312)	(312)
Accrued interest payable	(2,918)	(125)	(2,790)	(3)	(2,918)

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

Cash and cash equivalents - The carrying amount of cash and cash equivalents approximate fair value and are classified as Level 1.

Loans, net – Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans, 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 current market rates applied to the estimated life resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

Federal Home Loan Bank stock and Federal Reserve Bank stock– It is not practical to determine the fair value of Federal Home Loan Bank stock and Federal Reserve Bank stock due to restrictions placed on its transferability.

Certificates of deposit - Fair values of certificates of deposit are estimated using discounted cash flow analyses using current market rates applied to the estimated life resulting in a Level 2 classification.

All other deposits- The fair values for all other deposits other than certificates of deposit are equal to the amount payable on demand (the carrying value) resulting in a Level 1 classification.

Securities sold under agreements to repurchase – The carrying amount of borrowings under repurchase agreements approximates their fair values resulting in a Level 2 classification.

Federal funds purchased – The carrying amount of federal funds purchased approximates their fair values resulting in a Level 2 classification.

Other short-term borrowings – The fair value of other short-term borrowings approximates their fair values resulting in a Level 2 classification.

Long-term borrowings – The fair value of long-term borrowings is estimated using discounted cash flow analyses based on current borrowing rates resulting in a Level 2 classification.

Subordinated debentures - The fair value of subordinated debentures is based on the rates currently available to the Company with similar term and remaining maturity and credit spread resulting in a Level 3 classification.

Standby letters of credit – The fair value of off-balance sheet items is based on the current fees and costs that would be charged to enter into or terminate such arrangements resulting in a Level 3 classification.

Accrued interest receivable/payable – The carrying amounts of accrued interest approximates fair value resulting in a Level 1, Level 2 or Level 3 classification which is consistent with its associated asset/liability.

#### NOTE 6. EMPLOYEE BENEFIT PLANS

Components of net periodic benefit cost:

(dollars in thousands)	Three Months Ended March 31,			
	Pension Benefits		SERP Benefits	
	2014	2013	2014	2013
Interest cost	\$ 30	\$ 32	\$ 12	\$ 13
Expected return on plan assets	(31)	(35)	(18)	(19)
Recognized net actuarial (gain) loss	29	34	20	21
Net pension expense (benefit)	\$ 28	\$ 31	\$ 14	\$ 15

The Company previously disclosed in its financial statements for the year ended December 31, 2013 that it expected to contribute \$207,000 to its pension plan and \$4,000 to its Supplemental Executive Retirement Plan (“SERP”) in

2014. The Company has contributed \$0 to its pension plan and \$4,000 to its SERP as of March 31, 2014. The Company expects to contribute \$207,000 to its pension plan during the remainder of 2014. The Company does not expect to make any additional contributions to its SERP during the remainder of 2014.



## NOTE 7. OFFSETTING ASSETS AND LIABILITIES

The following tables summarize gross and net information about financial instruments and derivative instruments that are offset in the statement of financial position or that are subject to an enforceable master netting arrangement at March 31, 2014 and December 31, 2013.

(dollars in thousands)	March 31, 2014						Net Amount
	Gross Amounts of Recognized	Gross Amounts Offset in the Statement of	Net Amounts of Assets presented in the Statement	Gross Amounts Not Offset in the Statement of Financial Position	Cash Collateral		
	Assets/ Liabilities	Financial Position	of Financial Position	Financial Instruments	Received		
<b>Assets</b>							
Interest rate swap derivatives	\$ 640	\$ 0	\$ 640	\$ 0	\$ 0		\$ 640
Total assets	\$ 640	\$ 0	\$ 640	\$ 0	\$ 0		\$ 640
<b>Liabilities</b>							
Interest rate swap derivatives	\$ 629	\$ 0	\$ 629	\$ 0	\$ 0		\$ 629
Repurchase agreements	81,361	0	81,361	(81,361)	0		0
Total liabilities	\$ 81,990	\$ 0	\$ 81,990	\$ (81,361)	\$ 0		\$ 629

(dollars in thousands)	December 31, 2013						Net Amount
	Gross Amounts of Recognized	Gross Amounts Offset in the Statement of	Net Amounts of Assets presented in the Statement	Gross Amounts Not Offset in the Statement of Financial Position	Cash Collateral		
	Assets/ Liabilities	Financial Position	of Financial Position	Financial Instruments	Received		
<b>Assets</b>							
Interest rate swap derivatives	\$ 627	\$ 0	\$ 627	\$ 0	\$ (260)		\$ 367
Total assets	\$ 627	\$ 0	\$ 627	\$ 0	\$ (260)		\$ 367
<b>Liabilities</b>							
Interest rate swap derivatives	\$ 592	\$ 0	\$ 592	\$ 0	\$ 0		\$ 592
Repurchase agreements	104,876	0	104,876	(104,876)	0		0
Total liabilities	\$ 105,468	\$ 0	\$ 105,468	\$ (104,876)	\$ 0		\$ 592

If an event of default occurs causing an early termination of an interest rate swap derivative, any early termination amount payable to one party by the other party may be reduced by set-off against any other amount payable by the one

party to the other party. If a default in performance of any obligation of a repurchase agreement occurs, each party will set-off property held in respect of transactions against obligations owing in respect of any other transactions.

#### NOTE 8. EARNINGS PER SHARE

Basic earnings per common share is net income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options, stock awards and warrants, none of which were antidilutive.

	Three Months Ended March 31,	
	2014	2013
Weighted average shares outstanding for basic earnings per common share	16,513,645	16,408,710
Dilutive effect of stock options, awards and warrants	200,208	118,461
Weighted average shares outstanding for diluted earnings per common share	16,713,853	16,527,171
Basic earnings per common share	\$ 0.60	\$ 0.56
Diluted earnings per common share	\$ 0.59	\$ 0.56

## NOTE 9. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss) for the three months ended March 31, 2014 and 2013:

(dollars in thousands)	Unrealized Gains and Losses on Available- for-Sales Securities	Defined Benefit Pension Items	Total
Balance at December 31, 2013	\$ (1,138)	\$ (1,356)	\$ (2,494)
Other comprehensive income before reclassification	2,887	31	2,918
Amounts reclassified from accumulated other comprehensive income (loss)	0	30	30
Net current period other comprehensive income	2,887	61	2,948
Balance at March 31, 2014	\$ 1,749	\$ (1,295)	\$ 454

(dollars in thousands)	Unrealized Gains and Losses on Available- for-Sales Securities	Defined Benefit Pension Items	Total
Balance at December 31, 2012	\$ 7,517	\$ (1,828)	\$ 5,689
Other comprehensive income before reclassification	(643)	(90)	(733)
Amounts reclassified from accumulated other comprehensive income (loss)	(1)	33	32
Net current period other comprehensive income	(644)	(57)	(701)
Balance at March 31, 2013	\$ 6,873	\$ (1,885)	\$ 4,988

Reclassifications out of accumulated comprehensive income for the three months ended March 31, 2014 are as follows:

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified From Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
(dollars in thousands)		
Amortization of defined benefit pension items	\$ (49)	Salaries and employee benefits
Tax effect	19	Income tax expense
Total reclassifications for the period	\$ (30)	Net of tax

Amounts in parenthesis indicate a decrease in net income.

Reclassifications out of accumulated comprehensive income for the three months ended March 31, 2013 are as follows:

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified From Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
(dollars in thousands)		
Unrealized gains and losses on available-for-sale securities	\$ 1	Net securities gains (losses)
Tax effect		0 Income tax expense
		1 Net of tax
Amortization of defined benefit pension items(1)	(55)	Salaries and employee benefits
Tax effect		22 Income tax expense
		(33) Net of tax
Total reclassifications for the period	\$ (32)	Net of tax

#### NOTE 10. NEW ACCOUNTING PRONOUNCEMENTS

In January 2014, the FASB issued updated guidance related to the accounting for investments in qualified affordable housing projects. The amendment permits reporting entities to make an accounting policy election to account for investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). To qualify for the proportional amortization method, all of the following conditions must be met: 1. It is probable that the tax credits allocable to the investor will be available. 2. The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity. 3. Substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment). 4. The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive. 5. The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment. The decision to apply the proportional amortization method of accounting is an accounting policy decision that should be applied consistently to all qualifying affordable housing project investments rather than a decision to be applied to individual investments. For those investments in qualified affordable housing projects not accounted for using the proportional amortization method, the investment should be accounted for as an equity method investment or a cost method investment in accordance with Subtopic 970-323. The new requirements are effective for public companies in fiscal years, and interim periods within those years, beginning after December 15, 2014. Adopting this standard is not expected to have a significant impact on the Company's financial condition or results of operations.

In January 2014, the FASB issued updated guidance related to the reclassification of residential real estate collateralized consumer mortgage loans upon foreclosure. The amendments in this Update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The new requirements are effective for public companies in fiscal years, and interim periods within those years, beginning after December 15, 2014. Adopting this standard is not expected to have a significant impact on the Company's financial condition or results of operations.

#### NOTE 11. SUBSEQUENT EVENTS

There were no subsequent events that would have a material impact on the financial statements presented in this Form 10-Q.

#### NOTE 12. RECLASSIFICATIONS

Certain amounts appearing in the financial statements and notes thereto for prior periods have been reclassified to conform with the current presentation. The reclassification had no effect on net income or stockholders' equity as previously reported.



## ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### OVERVIEW

Net income in the first three months of 2014 was \$9.9 million, up 7.2% from \$9.2 million for the comparable period of 2013. Diluted income per common share was \$0.59 in the first three months of 2014, up 5.4% from \$0.56 in the comparable period of 2013. Return on average total assets was 1.26% in the first three months of 2014 versus 1.27% in the comparable period of 2013. The equity to average assets ratio was 10.29% in the first three months of 2014 versus 10.30% in the comparable period of 2013.

Total assets were \$3.234 billion as of March 31, 2014 versus \$3.176 billion as of December 31, 2013, an increase of \$58.0 million, or 1.8%. This increase was primarily due to a \$39.1 million increase in total loans.

### CRITICAL ACCOUNTING POLICIES

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Some of the facts and circumstances which could affect these judgments include changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses and the valuation and other-than-temporary impairment of investment securities.

#### Allowance for Loan Losses

The Company maintains an allowance for loan losses to provide for probable incurred credit losses. Loan losses are charged against the allowance when management believes that the principal is uncollectable. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance are made for specific loans and for pools of similar types of loans, although the entire allowance is available for any loan that, in management's judgment, should be charged against the allowance. A provision for loan losses is taken based on management's ongoing evaluation of the appropriate allowance balance. A formal evaluation of the adequacy of the loan loss allowance is conducted monthly. The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control.

The level of loan loss provision is influenced by growth in the overall loan portfolio, emerging market risk, emerging concentration risk, commercial loan focus and large credit concentration, new industry lending activity, general economic conditions and historical loss analysis. In addition, management gives consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Furthermore, management's overall view on credit quality is a factor in the determination of the provision.

The determination of the appropriate allowance is inherently subjective, as it requires significant estimates by management. The Company has an established process to determine the adequacy of the allowance for loan losses that generally includes consideration of the following factors: changes in the nature and volume of the loan portfolio, overall portfolio quality and current economic conditions that may affect the borrowers' ability to repay. Consideration is not limited to these factors although they represent the most commonly cited factors. With respect to specific allocation levels for individual credits, management considers the amounts and timing of expected future cash flows and the current valuation of collateral as the primary measures. Management also considers trends in adversely classified loans based upon an ongoing review of those credits. With respect to pools of similar loans, allocations are assigned based upon historical experience unless the rate of loss is expected to be greater than historical losses as

noted below. A detailed analysis is performed on loans that are classified but determined not to be impaired which incorporates probability of default with a loss given default scenario to develop non-specific allocations for the loan pool. These allocations may be adjusted based on the other factors cited above. An appropriate level of general allowance for pooled loans is determined after considering the following: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentration, new industry lending activity and general economic conditions. It is also possible that the following could affect the overall process: social, political, economic and terrorist events or activities. All of these factors are susceptible to change, which may be significant. As a result of this detailed process, the allowance results in two forms of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover probable losses inherent in the loan portfolio.

Commercial loans are subject to a dual standardized grading process administered by the credit administration function. These grade assignments are performed independent of each other and a loan may or may not be graded the same. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that indicate the loan is impaired. Considerations with respect to specific allocations for these individual credits include, but are not limited to, the following: (a) does the customer's cash flow or net worth appear insufficient to repay the loan; (b) is there adequate collateral to repay the loan; (c) has the loan been criticized in a regulatory examination; (d) is the loan impaired; (e) are there other reasons where the ultimate collectability of the loan is in question; or (f) are there unique loan characteristics that require special monitoring.



Allocations are also applied to categories of loans considered not to be individually impaired, but for which the rate of loss is expected to be consistent with or greater than historical averages. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values. In addition, general allocations are made for other pools of loans, including non-classified loans. These general pooled loan allocations are performed for portfolio segments of commercial and industrial, commercial real estate and multi-family, agri-business and agricultural, other commercial, consumer 1-4 family mortgage and other consumer 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, subjectively adjusted for economic factors and portfolio trends.

Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses includes an unallocated component. The unallocated component of the allowance for loan losses incorporates the Company's determination, based on its judgment, of inherent losses that may not be fully reflected in other allocations, including factors such as the level of classified credits, economic uncertainties, industry trends impacting specific portfolio segments, broad portfolio quality trends and trends in the composition of the Company's large commercial loan portfolio and related large dollar exposures to individual borrowers.

#### Valuation and Other-Than-Temporary Impairment of Investment Securities

The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges or pricing models, which utilize significant observable inputs such as matrix pricing. This is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Different judgments and assumptions used in pricing could result in different estimates of value. The fair value of certain securities is determined using unobservable inputs, primarily observable inputs of similar securities.

At the end of each reporting period, securities held in the investment portfolio are evaluated on an individual security level for other-than-temporary impairment in accordance with current accounting guidance. Impairment is other-than-temporary if the decline in the fair value of the security is below its amortized cost and it is probable that all amounts due according to the contractual terms of a debt security will not be received.

Significant judgments are required in determining impairment, which includes making assumptions regarding the estimated prepayments, loss assumptions and the change in interest rates.

We consider the following factors when determining other-than-temporary impairment for a security or investment:

- the length of time and the extent to which the market value has been less than amortized cost;
- the financial condition and near-term prospects of the issuer;
- the underlying fundamentals of the relevant market and the outlook for such market for the near future; and
- our intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in market value.

An additional independent analysis was performed for the non-agency residential mortgage-backed securities to determine if other-than-temporary impairment needed to be recorded for these securities. The independent analysis utilized third party data sources which were then included in projections of the cash flows of the individual securities under several different scenarios based upon assumptions of collateral defaults, prepayment speeds, expected losses and the severity of potential losses. Based upon the initial review using the analysis created with third party sources, securities were identified for further analysis. For any that were identified, management made assumptions as to prepayment speeds, default rates, severity of losses and lag time until losses are actually recorded for each security

based upon historical data for each security and other factors. Cash flows for each security using these assumptions were generated and the net present value was computed using an appropriate discount rate (the original accounting yield) for the individual security. The net present value was then compared to the book value of the security to determine if there was any other-than-temporary impairment that must be recorded. During 2013, all non-agency mortgage-backed securities owned as of December 31, 2012 were sold and no additional non-agency mortgage-backed securities were purchased.

If, in management's judgment, other-than-temporary impairment exists, the cost basis of the security will be written down to the computed net present value, and the unrealized loss will be transferred from accumulated other comprehensive loss as an immediate reduction of current earnings (as if the loss had been realized in the period of other-than-temporary impairment). In addition, discount accretion will be discontinued on any bond that meets one or both of the following: (1) the rating by S&P, Moody's or Fitch decreases to below "A" and/or (2) the cash flow analysis on a security indicates under any scenario modeled by the third party there is a potential to not receive the full amount invested in the security.

## RESULTS OF OPERATIONS

### Overview

Selected income statement information for the three months ended March 31, 2014 and 2013 is presented in the following table:

(dollars in thousands)	2014	2013
Income Statement Summary:		
Net interest income	\$ 24,680	\$ 21,257
Provision for loan losses	0	0
Noninterest income	7,427	7,481
Noninterest expense	16,790	14,893
Other Data:		
Efficiency ratio	52.29%	51.82%
Dilutive EPS	\$ 0.59	\$ 0.56
Tangible capital ratio	10.18%	10.38%
Net charge-offs to average loans	0.42%	0.11%

### Net Income

Net income was \$9.9 million in the first three months of 2014, an increase of \$666,000, or 7.2%, versus net income of \$9.2 million in the first three months of 2013. Net interest income increased \$3.4 million, or 16.1%, to \$24.7 million versus \$21.3 million in the first three months of 2013. Net interest income increased primarily due to a 9.2% increase in average earning assets. Significantly affecting average earning assets during 2014 was an increase of 15.0% in the commercial loan portfolio, which reflects our continuing strategic focus on commercial lending. In addition, noninterest bearing demand deposits increased while time deposits, which typically pay a higher rate of interest, decreased. The net interest margin was 3.38% in the first three months of 2014 versus 3.17% in 2013. The higher margin reflected a decline in funding costs offset by lower yields on earning assets.

Net income in the first three months of 2014 was negatively impacted by a non-cash provision for state income tax expense of \$431,000, which resulted from a revaluation of the Company's state deferred tax items. During the first quarter of 2014, the Indiana legislature approved new tax rates for financial institutions. The tax rate, currently 8.0%, is scheduled to drop to 6.5% for 2017. The new legislation further reduces the rate to 4.9%, phased-in beginning in 2019. One effect of the lower, future rates is to reduce the benefit that will be provided by the Company's existing net deferred tax asset items requiring the non-cash adjustment. Excluding the effect of the adjustment, net income for the first three months of 2014 would have been \$10.3 million, representing an increase of 11.9% over the comparable period of 2013.



## Net Interest Income

The following tables set forth consolidated information regarding average balances and rates:

(fully tax equivalent basis, dollars in thousands)	Three Months Ended March 31,					
	2014			2013		
	Average Balance	Interest Income	Yield (1)/ Rate	Average Balance	Interest Income	Yield (1)/ Rate
<b>Earning assets</b>						
<b>Loans:</b>						
Taxable (2)(3)	\$ 2,530,356	\$ 25,334	4.06%	\$ 2,246,688	\$ 24,486	4.42%
Tax exempt (1)	8,266	148	7.27	8,817	154	7.08
<b>Investments: (1)</b>						
Available for sale	473,184	3,251	2.79	478,098	2,045	1.74
Short-term investments	5,480	1	0.07	9,157	2	0.09
Interest bearing deposits	4,154	7	0.68	25,168	22	0.35
Total earning assets	\$ 3,021,440	\$ 28,741	3.86%	\$ 2,767,928	\$ 26,709	3.91%
Less: Allowance for loan losses	(48,592)			(51,645)		
<b>Nonearning Assets</b>						
Cash and due from banks	61,742			82,210		
Premises and equipment	39,627			34,716		
Other nonearning assets	112,916			110,558		
Total assets	\$ 3,187,133			\$ 2,943,767		
<b>Interest bearing liabilities</b>						
Savings deposits	\$ 242,161	\$ 134	0.22%	\$ 216,828	\$ 172	0.32%
Interest bearing checking accounts	1,099,980	1,062	0.39	999,319	1,640	0.67
Time deposits:						
In denominations under \$100,000	285,467	823	1.17	352,509	1,300	1.50
In denominations over \$100,000	551,290	1,168	0.86	523,738	1,525	1.18
Miscellaneous short-term borrowings	170,733	151	0.36	114,105	91	0.32
Long-term borrowings and subordinated debentures (4)	30,964	252	3.30	36,798	307	3.38
Total interest bearing liabilities	\$ 2,380,595	\$ 3,590	0.61%	\$ 2,243,297	\$ 5,035	0.91%
<b>Noninterest bearing liabilities</b>						

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Demand deposits	463,664	380,759
Other liabilities	14,816	16,485
Stockholders' equity	328,058	303,226
Total liabilities and stockholders' equity	\$ 3,187,133	\$ 2,943,767

Interest Margin Recap

Interest income/average earning assets	28,741	3.86	26,709	3.91
Interest expense/average earning assets	3,590	0.48	5,035	0.74
Net interest income and margin	\$ 25,151	3.38%	\$ 21,674	3.17%

- (1) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2014 and 2013. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") adjustment applicable to nondeductible interest expenses.
- (2) Loan fees, which are immaterial in relation to total taxable loan interest income for the three months ended March 31, 2014 and 2013, are included as taxable loan interest income.
- (3) Nonaccrual loans are included in the average balance of taxable loans.

Net interest income increased \$3.4 million, or 16.2%, for the three months ended March 31, 2014 compared with the first three months of 2013. The increased level of net interest income during the first quarter of 2014 compared with the first quarter of 2013 was largely driven by an increase in net earning assets as well as a deceleration in the amortization of premiums on agency mortgage-backed securities. The deceleration was primarily the result of rising long-term mortgage interest rates which have reduced prepayments in the loans underlying the securities. In addition, the Company's cost of funds decreased by 26 basis points during the first three months of 2014 compared to the first three months of 2013. The tax equivalent net interest margin was 3.38% for the first three months of 2014 compared to 3.17% during the first three months of 2013. The yield on earning assets totaled 3.86% during the three months ended March 31, 2014 compared to 3.91% in the same period of 2013 while the cost of funds (expressed as a percentage of average earning assets) totaled 0.48% during the first three months of 2014 compared to 0.74% in the same period of 2013.

The decline in the yield on earning assets in the first three months of 2014 compared with the first three months of 2013 was largely attributable to the continued downward pressure on commercial loan yields being driven by a historically low market interest rate environment and a competitive marketplace for lending opportunities. The decline was also caused in part by the scheduled amortization of existing fixed rate commercial loans. The decline was mitigated by the deceleration in premium amortization of agency mortgage-backed securities. The decline in the Company's cost of funds by approximately 26 basis points during the first three months of 2014 compared to the first three months 2013 was largely driven by a continued decline in deposit rates as well as an increase of \$82.9 million in average noninterest bearing demand deposits.

Average earning assets increased by \$253.5 million for the three months ended March 31, 2014 compared with the same period of 2013. Average loans outstanding increased \$283.1 million during the three months ended March 31, 2014 compared with the first three months of 2013, with most of the growth being in commercial loans. The average securities portfolio decreased \$4.9 million in the three months ended March 31, 2014 compared with the first three months of 2013.

#### Provision for Loan Losses

No provisions for loan loss expense were recorded during the three-month periods ended March 31, 2014 and 2013. The allowance for loan losses represented 1.79% of the loan portfolio, versus 1.92% at December 31, 2013 and 2.25% at March 31, 2013. Factors impacting the decision not to record a provision in the first three months of 2014 included the stabilization or improvement in key loan quality metrics including strong reserve coverage of nonperforming loans, a decrease in historical loss percentages, continuing signs of stabilization in economic conditions in the Company's markets and general signs of improvement in borrower performance and future prospects. In addition, management gave consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Management's overall view on current credit quality was also a factor in the determination of the provision for loan losses. The Company's management continues to monitor the adequacy of the provision based on loan levels, asset quality, economic conditions and other factors that may influence the assessment of the collectability of loans.

#### Noninterest Income

Noninterest income categories for the three-month periods ended March 31, 2014 and 2013 are shown in the following table:

(dollars in thousands)	Three Months Ended March 31,		Percent Change
	2014	2013	
Wealth advisory fees	\$ 1,039	\$ 944	10.1%
Investment brokerage fees	1,117	949	17.7
Service charges on deposit accounts	2,151	1,971	9.1
Loan, insurance and service fees	1,458	1,456	0.1
Merchant card fee income	350	276	26.8
Bank owned life insurance	372	393	(5.3)
Other income	875	982	(10.9)
Mortgage banking income	65	509	(87.2)
Net securities gains (losses)	0	1	N/A
Total noninterest income	\$ 7,427	\$ 7,481	(0.7)%
Noninterest income to total revenue	23.1%	26.0%	

The Company's noninterest income decreased 1% to \$7.4 million for the first quarter of 2014 from \$7.5 million for the first quarter of 2013. On a year-over-year basis, quarterly noninterest income was negatively impacted by a \$444,000 decrease in mortgage banking income, driven by lower production volumes due to higher long-term mortgage rates. Service charges on deposit accounts increased by \$180,000 driven by increases in account analysis service charges on commercial checking accounts, and investment brokerage fees increased by \$168,000 driven by a shift towards fixed income investments by clients, which generally have a more favorable revenue impact to the Company.



## Noninterest Expense

Noninterest expense categories for the three-month periods ended March 31, 2014 and 2013 are shown in the following table:

(dollars in thousands)	Three Months Ended		Percent Change
	2014	March 31, 2013	
Salaries and employee benefits	\$ 9,987	\$ 9,165	9.0%
Net occupancy expense	1,110	846	31.2
Equipment costs	773	609	26.9
Data processing fees and supplies	1,491	1,293	15.3
Corporate and business development	416	406	2.5
FDIC insurance and other regulatory fees	477	463	3.0
Professional fees	800	595	34.5
Other expense	1,736	1,516	14.5
Total noninterest expense	\$ 16,790	\$ 14,893	12.7%

The Company's noninterest expense increased \$1.9 million, or 13%, to \$16.8 million in the first quarter of 2014 versus \$14.9 million in the comparable quarter of 2013. Salaries and employee benefits increased by \$822,000 in the three month period ended March 31, 2014 versus the same period of 2013. These increases in salary and employee benefits were driven by staff additions, normal merit increases and higher performance and incentive-based compensation costs such as investment brokerage sales commissions. Quarterly net occupancy expense increased \$264,000 driven by higher snow removal costs. Professional fees increased \$205,000 due to higher legal expenses as well as fees associated with the search for a new Chief Financial Officer, who took office in the second quarter. Data processing fees increased by \$198,000 due to a larger customer base as well as greater utilization of services from the Company's core processor, which the Company expects will improve marketing and cross-selling initiatives. In addition, equipment costs increased \$164,000 during the first quarter of 2014, driven by higher depreciation expenses related to operating leases. The Company's efficiency ratio was 52.3% for the first quarter of 2014 versus 51.8% for the comparable period of 2013.

## Income Taxes

Income tax expense increased \$806,000, or 17.5%, for the first three months of 2014, compared to the same period in 2013. The combined state franchise tax expense and the federal income tax expense, as a percentage of income before income tax expense, increased to 35.3% during the first three months of 2014 compared to 33.2% during the same period of 2013. The increase was driven by the previously disclosed \$431,000 provision for state income tax expense due to a revaluation of the Company's state net deferred tax asset items. Excluding the effect of the adjustment, income taxes for the three months ended March 31, 2014 would have been \$5.0 million, representing 32.5% of pretax net income.

## FINANCIAL CONDITION

## Overview

Total assets of the Company were \$3.234 billion as of March 31, 2014, an increase of \$58.0 million, or 1.8%, when compared to \$3.176 billion as of December 31, 2013. Total loans increased by \$39.1 million, or 1.5%, to \$2.574 billion at March 31, 2014 from \$2.535 billion at December 31, 2013. Funding for the loan growth came from a

\$192.7 million increase in deposits offset by a \$147.5 million decrease in short-term borrowings.

## Uses of Funds

## Investment Portfolio

The amortized cost and the fair value of securities as of March 31, 2014 and December 31, 2013 were as follows:

(dollars in thousands)	March 31, 2014		December 31, 2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. Treasury securities	\$ 1,000	\$ 1,011	\$ 1,001	\$ 1,017
Agency residential mortgage-backed securities	372,570	373,424	374,611	371,977
State and municipal securities	95,121	97,014	95,388	95,973
Total	\$ 468,691	\$ 471,449	\$ 471,000	\$ 468,967

At March 31, 2014 and December 31, 2013, there were no holdings of securities of any one issuer, other than the U.S. government, government agencies and government sponsored agencies, in an amount greater than 10% of stockholders' equity.

Purchases of securities available for sale totaled \$13.5 million in the first three months of 2014. Paydowns from prepayments and scheduled payments of \$13.2 million were received in the first three months of 2014, and the amortization of premiums, net of the accretion of discounts, was \$1.5 million. Maturities and calls of securities totaled \$1.0 million in the first three months of 2014. No other-than-temporary impairment was recognized in the first three months of 2014. The investment portfolio is managed to provide for an appropriate balance between, liquidity, credit risk and investment return and to limit the Company's exposure to risk to an acceptable level. The Company does not trade or invest in or sponsor certain unregistered investment companies defined as hedge funds and private equity funds in the Volcker Rule.

## Real Estate Mortgage Loans HFS

Real estate mortgage loans held-for-sale increased by \$265,000, or 14.9%, to \$2.0 million at March 31, 2014, from \$1.8 million at December 31, 2013. The balance of this asset category is subject to a high degree of variability depending on, among other things, recent mortgage loan rates and the timing of loan sales into the secondary market. The Company generally sells all of the mortgage loans it originates on the secondary market. Proceeds from sales totaled \$6.9 million in the first three months of 2014.

## Loan Portfolio

The loan portfolio by class as of March 31, 2014 and December 31, 2013 is summarized as follows:

(dollars in thousands)	March 31, 2014			December 31, 2013			Current Period Change
	\$	%		\$	%		
Commercial and industrial loans	\$ 944,497	36.7	%	\$ 901,567	35.6	%	\$ 42,930
Commercial real estate and multi-family residential loans	1,015,055	39.4		986,207	38.9		28,848
Agri-business and agricultural loans	213,644	8.3		254,029	10.0		(40,385)
Other commercial loans	77,324	3.0		70,770	2.8		6,554
Consumer 1-4 family mortgage loans	279,954	10.9		277,030	10.9		2,924

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Other consumer loans	44,319	1.7		46,125	1.8		(1,806)
Subtotal	2,574,793	100.0	%	2,535,728	100.0	%	39,065
Less: Allowance for loan losses	(46,137)			(48,797)			2,660
Net deferred loan fees	(603)			(630)			27
Loans, net	\$ 2,528,053			\$ 2,486,301			\$ 41,752

Total loans, excluding real estate mortgage loans held for sale, increased by \$39.1 million to \$2.575 billion at March 31, 2014 from \$2.536 billion at December 31, 2013. The increase was concentrated in the commercial and commercial real estate categories and reflected the Company's long standing strategic plan that is focused on expanding and growing the commercial lending business throughout our market areas. The increase was partially offset by seasonal declines in agri-business loans.

The following table summarizes the Company's non-performing assets as of March 31, 2014 and December 31, 2013:

(dollars in thousands)	March 31, 2014	December 31, 2013
Nonaccrual loans including nonaccrual troubled debt restructured loans	\$ 15,082	\$ 23,899
Loans past due over 90 days and still accruing	20	46
Total nonperforming loans	\$ 15,102	\$ 23,945
Other real estate owned	1,192	469
Repossessions	9	12
Total nonperforming assets	\$ 16,303	\$ 24,426
Impaired loans including troubled debt restructurings	\$ 34,101	\$ 43,218
Nonperforming loans to total loans	0.59%	0.94%
Nonperforming assets to total assets	0.50%	0.77%
Performing troubled debt restructured loans	\$ 16,222	\$ 17,714
Nonperforming troubled debt restructured loans (included in nonaccrual loans)	10,721	18,531
Total troubled debt restructured loans	\$ 26,943	\$ 36,245

Total nonperforming assets decreased by \$8.1 million, or 33.3%, to \$16.3 million during the three-month period ended March 31, 2014. The decrease in nonperforming assets primarily resulted from the sale, to an independent party, of a single commercial relationship consisting of three loans totaling \$6.7 million. The three loans were accounted for as troubled debt restructurings. The Company received proceeds of \$4.3 million and recognized charge offs of \$2.4 million as a result of the sale. The amount charged-off had previously been reserved for by the Company. In addition, one commercial credit of \$1.4 million was removed from the impaired category due to improved performance.

Net charge-offs totaled \$2.6 million in the first quarter of 2014, versus net charge-offs of \$626,000 during the first quarter of 2013 and net charge-offs of \$1.0 million during the fourth quarter of 2013.

A loan is impaired when full payment under the original loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature not in nonaccrual or troubled debt restructured status such as residential mortgage, consumer, and credit card loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flow or at the fair value of collateral if repayment is expected solely from the collateral.

Total impaired loans decreased by \$9.1 million, or 21.1%, to \$34.1 million at March 31, 2014 from \$43.2 million at December 31, 2013. The decrease in the impaired loans category was primarily due to the sale proceeds received and charge offs recognized on a single commercial relationship consisting of three impaired loans totaling \$6.7 million. In addition, one commercial credit of \$1.4 million was removed from the impaired category due to improved performance.

At March 31, 2014, the allowance for loan losses was 1.79% of total loans outstanding, versus 1.92% of total loans outstanding, at December 31, 2013. At March 31, 2014, management believes the allowance for loan losses was at a level commensurate with the overall risk exposure of the loan portfolio. However, if economic conditions do not continue to improve, certain borrowers may experience difficulty and the level of nonperforming loans, charge-offs and delinquencies could rise and require increases in the allowance for loan losses. The process of identifying

probable credit losses is a subjective process. Therefore, the Company maintains a general allowance to cover probable incurred credit losses within the entire portfolio. The methodology management uses to determine the adequacy of the loan loss reserve includes the considerations below.

Loans are charged against the allowance for loan losses when management believes that the principal is uncollectible. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb probable incurred credit losses relating to specifically identified loans based on an evaluation of the loans by management, as well as other probable incurred losses inherent in the loan portfolio. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to repay. Management also considers trends in adversely classified loans based upon a monthly review of those credits. An appropriate level of general allowance is determined after considering the following factors: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentrations, new industry lending activity and current economic conditions. Federal regulations require insured institutions to classify their own assets on a regular basis. The regulations provide for three categories of classified loans: Substandard, Doubtful and Loss. The regulations also contain a Special Mention category. Special Mention is defined as loans that do not currently expose an insured institution to a sufficient degree of risk to warrant classification as Substandard, Doubtful or Loss but do possess credit deficiencies or potential weaknesses deserving management's close attention. The Company's policy is to establish a specific allowance for loan losses for any assets where management has identified conditions or circumstances that indicate an asset is impaired. If an asset or portion thereof is classified as loss, the Company's policy is to either establish specified allowances for loan losses in the amount of 100% of the portion of the asset classified loss or charge-off such amount.

The Company has a relatively high percentage of commercial and commercial real estate loans, most of which are extended to small or medium-sized businesses from a wide variety of industries. Generally, this type of lending has more credit risk than other types of lending because of the size and diversity of the credits. The Company manages this risk by adjusting its pricing to the perceived risk of each individual credit and by diversifying the portfolio by customer, product, industry and geography.

At March 31, 2014, on the basis of management's review of the loan portfolio, the Company had 98 credits totaling \$165.3 million on the classified loan list versus 98 credits totaling \$165.1 million on December 31, 2013. As of March 31, 2014, the Company had \$97.8 million of assets classified as Special Mention, \$65.8 million classified as Substandard, \$0 classified as Doubtful and \$0 classified as Loss as compared to \$90.4 million, \$72.1 million, \$0 and \$0, respectively at December 31, 2013.

Allowance estimates are developed by management after taking into account actual loss experience adjusted for current economic conditions. The Company has regular discussions regarding this methodology with regulatory authorities. Allowance estimates are considered a prudent measurement of the risk in the Company's loan portfolio and are applied to individual loans based on loan type. In accordance with current accounting guidance, the allowance is provided for losses that have been incurred as of the balance sheet date and is based on past events and current economic conditions and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. For a more thorough discussion of the allowance for loan losses methodology see the Critical Accounting Policies section of this Item 2.

The allowance for loan losses decreased 5.5%, or \$2.7 million, from \$48.8 million at December 31, 2013 to \$46.1 million at March 31, 2014. Pooled loan allocations increased from \$39.5 million at December 31, 2013 to \$40.1 million at March 31, 2014, which was due to an increase in pooled loan balances as well as management's view of current credit quality and the current economic environment. Impaired loan allocations decreased \$3.2 million from \$9.3 million at December 31, 2013 to \$6.1 million at March 31, 2014. This decrease in impaired allocations was primarily due to decreases in the allocations of existing impaired loans as well as reductions to the impaired loans category. The unallocated component of the allowance for loan losses was unchanged at \$3.5 million at March 31, 2014 and December 31, 2013. While general trends in the overall economy and credit quality were stable or favorable, the Company believes that the unallocated component is appropriate given the uncertainty that exists regarding near term economic conditions.

Most of the Company's loan growth has been concentrated in the commercial loan portfolio, which can result in overall asset quality being influenced by a small number of credits. Management has historically considered growth and portfolio composition when determining loan loss allocations. Management believes that it is prudent to continue to provide for loan losses in a manner consistent with its historical approach due to the loan growth described above and current economic conditions.

Economic conditions in the Company's markets have generally improved and stabilized, management is cautiously optimistic that the recovery is positively impacting its borrowers. While the recovery is not robust, commercial real estate activity and manufacturing growth is occurring. The Company's continued growth strategy promotes diversification among industries as well as continued focus on enforcement of a strong credit environment and an aggressive position in loan work-out situations. Although the Company believes that historical industry-specific issues in the Company's markets have improved and continue to be somewhat mitigated by its overall expansion strategy, the economic environment impacting its entire geographic footprint will continue to present challenges. While the Company has seen indications of improved economic conditions in its markets, they are not wide spread or particularly strong improvements.





## Sources of Funds

The following table summarizes deposits and borrowings as of March 31, 2014 and December 31, 2013:

(dollars in thousands)	March 31, 2014	December 31, 2013	Current Period Change
Non-interest bearing demand deposits	\$ 482,189	\$ 479,606	\$ 2,583
Interest bearing demand, savings & money market accounts	1,356,858	1,338,653	18,205
Time deposits under \$100,000	280,335	291,566	(11,231)
Time deposits of \$100,000 or more	619,392	436,243	183,149
Total deposits	2,738,774	2,546,068	192,706
Short-term borrowings	114,361	261,876	(147,515)
Long-term borrowings	35	37	(2)
Subordinated debentures	30,928	30,928	0
Total borrowings	145,324	292,841	(147,517)
Total funding sources	\$ 2,884,098	\$ 2,838,909	\$ 45,189

## Deposits and Borrowings

Total deposits increased by \$192.7 million, or 7.6%, from December 31, 2013. Most of the growth was concentrated in brokered time deposits of \$100,000 or more, public fund certificates of deposit of \$100,000 or more and money market accounts. The increase in money market balances as well as a decline in time deposits under \$100,000 is reflective of the ongoing low interest rate environment and consumers' desire to keep funds in a more liquid short-term deposit vehicle, in anticipation of higher rates in the future. Total brokered deposits were \$143.8 million at March 31, 2014 compared to \$29.8 million at December 31, 2013. Total public funds deposits, including public funds transaction accounts, were \$698.5 million at March 31, 2014 compared to \$549.7 at December 31, 2013.

Total borrowings decreased by \$147.5 million, or 50.4%, from December 31, 2013. Most of the decrease was concentrated in short-term advances from the Federal Home Loan Bank of Indianapolis as well as securities sold under agreements to repurchase. The Company uses wholesale funding, including brokered deposits, public funds and Federal Home Loan Bank advances, to augment deposit funding and to help maintain its desired interest rate risk position.

## Capital

As of March 31, 2014, total stockholders' equity was \$332.0 million, an increase of \$10.1 million, or 3.2%, from \$321.9 million at December 31, 2013. In addition to net income of \$9.9 million, other significant changes in equity during the first three months of 2014 included \$3.1 million of dividends paid. The accumulated other comprehensive income component of equity increased \$2.9 million during the three months ended March 31, 2014, driven by changes in the fair values of available-for-sale securities. The impact to equity due to other comprehensive income is not included in regulatory capital. The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1 or core capital as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations. The actual capital amounts and ratios of Lakeland Financial Corporation and Lake City Bank as of March 31, 2014 and December 31, 2013, are presented in the table below:



(dollars in thousands)	Actual		Minimum Required For Capital Adequacy Purposes		Minimum Required to Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of March 31, 2014:						
Total Capital (to Risk Weighted Assets)						
Consolidated	\$ 390,512	14.34%	\$ 217,857	8.00%	\$ 272,321	10.00%
Bank	\$ 381,103	14.03%	\$ 217,280	8.00%	\$ 271,601	10.00%
Tier I Capital (to Risk Weighted Assets)						
Consolidated	\$ 356,322	13.08%	\$ 108,929	4.00%	\$ 163,393	6.00%
Bank	\$ 347,002	12.78%	\$ 108,640	4.00%	\$ 162,960	6.00%
Tier I Capital (to Average Assets)						
Consolidated	\$ 356,322	11.20%	\$ 127,277	4.00%	\$ 159,096	5.00%
Bank	\$ 347,002	10.94%	\$ 126,904	4.00%	\$ 158,630	5.00%
As of December 31, 2013:						
Total Capital (to Risk Weighted Assets)						
Consolidated	\$ 382,951	14.23%	\$ 215,229	8.00%	\$ 269,036	10.00%
Bank	\$ 373,685	13.92%	\$ 214,704	8.00%	\$ 268,380	10.00%
Tier I Capital (to Risk Weighted Assets)						
Consolidated	\$ 349,134	12.98%	\$ 107,614	4.00%	\$ 161,422	6.00%
Bank	\$ 339,949	12.67%	\$ 107,352	4.00%	\$ 161,028	6.00%
Tier I Capital (to Average Assets)						
Consolidated	\$ 349,134	11.25%	\$ 124,152	4.00%	\$ 155,190	5.00%
Bank	\$ 339,949	10.98%	\$ 123,809	4.00%	\$ 154,761	5.00%

Beginning January 1, 2015, the Company and Bank will be subject to the new capital regulations of Basel III. The new regulations establish higher minimum risk-based capital ratio requirements, a new common equity Tier 1 risk-based capital ratio and a new capital conservation buffer. The new regulations also include revisions to the definition of capital and changes in the risk-weighting of certain assets. The new regulations establish definitions of “well-capitalized” including the capital conservation buffer, as a 7.0% common equity Tier 1 risk-based capital ratio, an 8.5% Tier 1 risk-based capital ratio and a 10.5% total risk-based capital ratio. The capital conservation buffer is being phased-in and will be in full effect beginning January 1, 2019. Under the new regulations, all financial institutions must maintain a Tier 1 leverage ratio of 4% to be considered “adequately capitalized” and 5% to be considered “well-capitalized.” Management has completed a preliminary analysis of the impact of these new regulations to the capital ratios of both the Company and the Bank and estimates that the ratios for both the Company and the Bank would exceed the new minimum capital ratio requirements for “well-capitalized” including the capital conservation buffer under Basel III if they were effective at March 31, 2014.

#### FORWARD-LOOKING STATEMENTS

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as "believe," "expect," "anticipate," "plan," "intend," "estimate," "may," "will," "would," "could," "should" or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries, are detailed in the "Risk Factors" section included under Item 1A. of Part I of our Form 10-K. In addition to the risk factors described in that section, there are other factors that may impact any public company, including ours, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries. These additional factors include, but are not limited to, the following:

- Legislative or regulatory changes or actions, including the "Dodd-Frank Wall Street Reform and Consumer Protection Act" and the regulations required to be promulgated thereunder, as well as rules recently implemented by the federal banking regulatory agencies concerning certain increased capital requirements, among other items, which may adversely affect the business of the Company and its subsidiaries.
  - The costs, effects and outcomes of existing or future litigation.
- Changes in accounting policies and practices, as may be adopted by state and federal regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public Company Accounting Oversight Board.
  - The ability of the Company to manage risks associated with the foregoing as well as anticipated.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

### ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate risk represents the Company's primary market risk exposure. The Company does not have a material exposure to foreign currency exchange risk, does not have any material amount of derivative financial instruments and does not maintain a trading portfolio. The Board of Directors annually reviews and approves the policy used to manage interest rate risk. The policy was last reviewed and approved in May 2013. The policy sets guidelines for balance sheet structure, which are designed to protect the Company from the impact that interest rate changes could have on net income but does not necessarily indicate the effect on future net interest income. The Company, through its Asset and Liability Committee, manages interest rate risk by monitoring the computer simulated earnings impact of various rate scenarios and general market conditions. The Company then modifies its long-term risk parameters by attempting to generate the types of loans, investments, and deposits that currently fit the Company's needs, as determined by its Asset and Liability Committee. This computer simulation analysis measures the net interest income impact of various interest rate scenario changes during the next twelve months. If the change in net interest income is less than 3% of primary capital, the balance sheet structure is considered to be within acceptable risk levels. As of March 31, 2014, the Company's potential pretax exposure was within the Company's policy limit and not significantly different from the potential pretax exposure from December 31, 2013.

### ITEM 4 – CONTROLS AND PROCEDURES

As required by Rules 13a-15(b) and 15d-15(b) under the Securities Exchange Act of 1934, management has evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures (as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e)) were effective as of March 31, 2014. Disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer

and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

During the quarter ended March 31, 2014, there were no changes to the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect its internal control over financial reporting.

## PART II – OTHER INFORMATION

## Item 1. Legal proceedings

There are no material pending legal proceedings to which the Company or its subsidiaries is a party other than ordinary routine litigation incidental to their respective businesses.

## Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A. of Part I of the Company's 2013 Form 10-K. Please refer to that section of the Company's Form 10-K and Item 2 of Part I of this Form 10-Q for disclosures regarding the risks and uncertainties related to the Company's business.

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

The following table provides information as of March 31, 2014 with respect to shares of common stock repurchased by the Company during the quarter then ended:

## Issuer Purchases of Equity Securities(a)

## ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Appropriate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
January 1-31	4,924	\$ 38.59	0	\$ 0
February 1-28	522	36.38	0	0
March 1-31	0	0	0	0
Total	5,446	\$ 38.38	0	\$ 0

- (a) The shares purchased during the periods were credited to the deferred share accounts of non-employee directors under the Company's directors' deferred compensation plan. These shares were purchased in the ordinary course of business and consistent with past practice.

## Item 3. Defaults Upon Senior Securities

None

## Item 4. Mine Safety Disclosures

N/A

Item 5. Other Information

None

Item 6. Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)

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- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 Interactive Data File

Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets as of March 31, 2014 and December 31, 2013; (ii) Consolidated Statements of Income for the three months ended March 31, 2014 and March 31, 2013; (iii) Consolidated Statements of Comprehensive Income for the three months ended March 31, 2014 and March 31, 2013; (iv) Consolidated Statements of Cash Flows for the three months ended March 31, 2014 and March 31, 2013; and (v) Notes to Unaudited Consolidated Financial Statements.



LAKELAND FINANCIAL CORPORATION

FORM 10-Q

March 31, 2014

Part II - Other Information

Signatures

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

LAKELAND FINANCIAL CORPORATION  
(Registrant)

Date: May 12, 2014                      /s/ David M. Findlay  
David M. Findlay – President and  
Chief Executive Officer

Date: May 12, 2014                      /s/ Lisa M. O’Neill  
Lisa M. O’Neill – Executive Vice President and  
Chief Financial Officer

Date: May 12, 2014                      /s/ Teresa A. Bartman  
Teresa A. Bartman – Senior Vice President-  
Finance and Controller

