UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

For the quarterly period ended September 30, 2014

OR

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from to .

Commission file number 1-13661

STOCK YARDS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Kentucky	**61-1137529**
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization)	Identification No.)

1040 East Main Street, Louisville, Kentucky 40206

(Address of principal executive offices including zip code)

(502) 582-2571

(Registrant s telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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 x No o

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:

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares of the registrant s Common Stock, no par value, outstanding as of October 23, 2014, was 14,710,796.

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

Consolidated Balance Sheets

September 30, 2014 and December 31, 2013

(In thousands, except share data)

		September 30, 2014 (Unaudited)		December 31, 2013
Assets				
Cash and due from banks	$	38,302	$	34,519
Federal funds sold		31,265		36,251
Cash and cash equivalents		69,567		70,770
Mortgage loans held for sale		4,069		1,757
Securities available-for-sale (amortized cost of $448,254 in 2014 and $493,066 in 2013)		449,572		490,031
Federal Home Loan Bank stock and other securities		6,347		7,347
Loans		1,785,320		1,721,350
Less allowance for loan losses		27,124		28,522
Net loans		1,758,196		1,692,828
Premises and equipment, net		38,821		39,813
Bank owned life insurance		29,879		29,180
Accrued interest receivable		5,629		5,712
Other assets		45,791		51,824
Total assets	$	2,407,871	$	2,389,262
Liabilities and Stockholders Equity				
Deposits:				
Non-interest bearing	$	491,677	$	423,350
Interest bearing		1,516,144		1,557,587
Total deposits		2,007,821		1,980,937
Securities sold under agreements to repurchase		66,955		62,615
Federal funds purchased		16,296		55,295
Accrued interest payable		128		128
Other liabilities		28,306		26,514
Federal Home Loan Bank advances		36,919		34,329
Total liabilities		2,156,425		2,159,818
Stockholders equity:				
Preferred stock, no par value. Authorized 1,000,000 shares; no shares issued or outstanding				
Common stock, no par value. Authorized 20,000,000 shares; issued and outstanding 14,703,802 and 14,608,556 shares in 2014 and 2013, respectively		9,898		9,581
Additional paid-in capital		36,711		33,255
Retained earnings		204,215		188,825
Accumulated other comprehensive income (loss)		622		(2,217)
Total stockholders equity		251,446		229,444
Total liabilities and stockholders equity	$	2,407,871	$	2,389,262

See accompanying notes to unaudited consolidated financial statements.

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Income (Unaudited)

For the three and nine months ended September 30, 2014 and 2013

(In thousands, except per share data)

	For three months ended September 30, 2014	For three months ended September 30, 2013	For nine months ended September 30, 2014	For nine months ended September 30, 2013
Interest income:				
Loans	$ 20,429	$ 20,233	$ 59,575	$ 58,762
Federal funds sold	73	63	215	215
Mortgage loans held for sale	54	57	128	177
Securities taxable	1,845	1,626	5,506	4,388
Securities tax-exempt	291	288	885	853
Total interest income	22,692	22,267	66,309	64,395
Interest expense:				
Deposits	1,065	1,209	3,319	3,833
Fed funds purchased	8	9	23	26
Securities sold under agreements to repurchase	37	38	100	106
Federal Home Loan Bank advances	219	221	621	657
Subordinated debentures		773		2,318
Total interest expense	1,329	2,250	4,063	6,940
Net interest income	21,363	20,017	62,246	57,455
(Credit) provision for loan losses	(2,100)	1,325	(400)	4,975
Net interest income after provision for loan losses	23,463	18,692	62,646	52,480
Non-interest income:				
Investment management and trust services	4,502	4,017	13,825	12,032
Service charges on deposit accounts	2,294	2,348	6,620	6,592
Bankcard transaction revenue	1,182	1,087	3,466	3,068
Mortgage banking revenue	641	995	1,951	3,370
Loss on sales of securities available for sale			(9)	(5)
Brokerage commissions and fees	539	456	1,506	1,693
Bank owned life insurance income	229	260	699	771
Gain on acquisition				449
Other	463	489	1,324	1,221
Total non-interest income	9,850	9,652	29,382	29,191
Non-interest expenses:				
Salaries and employee benefits	11,855	10,508	33,697	30,186
Net occupancy expense	1,422	1,522	4,431	4,188
Data processing expense	1,591	1,520	4,869	4,695
Furniture and equipment expense	269	269	796	846
FDIC insurance expense	340	348	1,032	1,055
Loss (gain) on other real estate owned	7	475	(342)	366
Acquisition costs				1,548
Other	3,225	2,929	9,471	9,088
Total non-interest expenses	18,709	17,571	53,954	51,972
Income before income taxes	14,604	10,773	38,074	29,699
Income tax expense	4,715	3,091	11,974	8,842
Net income	$ 9,889	$ 7,682	$ 26,100	$ 20,857

Net income per share:				
Basic	$ 0.68	$ 0.53	$ 1.79	$ 1.47
Diluted	$ 0.67	$ 0.53	$ 1.77	$ 1.47
Average common shares:				
Basic	14,574	14,408	14,542	14,144
Diluted	14,748	14,556	14,732	14,228

See accompanying notes to unaudited consolidated financial statements.

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Comprehensive Income (Unaudited)

For the three and nine months ended September 30, 2014 and 2013

(In thousands)

	Three months ended September 30, 2014	Three months ended September 30, 2013	Nine months ended September 30, 2014	Nine months ended September 30, 2013
Net income	$ 9,889	$ 7,682	$ 26,100	$ 20,857
Other comprehensive income, net of tax:				
Unrealized (losses) gains on securities available-for-sale:				
Unrealized (losses) gains arising during the period (net of tax of ($234), $45, $1,521 and ($2,974), respectively)	(435)	83	2,823	(5,523)
Reclassification adjustment for securities losses realized in income (net of tax of $0, $0, $3, and $2, respectively)			6	3
Unrealized gains on hedging instruments:				
Unrealized gains arising during the period (net of tax of $12, $0, $6 and $0, respectively)	23		10	
Other comprehensive (loss) income	(412)	83	2,839	(5,520)
Comprehensive income	$ 9,477	$ 7,765	$ 28,939	$ 15,337

See accompanying notes to unaudited consolidated financial statements.

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

Consolidated Statement of Changes in Stockholders Equity (Unaudited)

For the nine months ended September 30, 2014 and 2013

(In thousands, except per share data)

	Common stock Number of shares	Common stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Total
Balance December 31, 2012	13,915	$ 7,273	$ 17,731	$ 174,650	$ 5,421	$ 205,075
Net income				20,857		20,857
Other comprehensive income, net of tax					(5,520)	(5,520)
Stock compensation expense			1,473			1,473
Stock issued for exercise of stock options and dividend reinvestment plan	93	309	1,784	(124)		1,969
Stock issued for non- vested restricted stock	55	184	1,083	(1,267)		
Stock issued for acquisition	531	1,769	10,429			12,198
Cash dividends, $0.60 per share				(8,602)		(8,602)
Shares repurchased or cancelled	(40)	(137)	(882)	104		(915)
Balance September 30, 2013	14,554	$ 9,398	$ 31,618	$ 185,618	$ (99)	$ 226,535
Balance December 31, 2013	14,609	$ 9,581	$ 33,255	$ 188,825	$ (2,217)	$ 229,444
Net income				26,100		26,100
Other comprehensive loss, net of tax					2,839	2,839
Stock compensation expense			1,459			1,459
Stock issued for exercise of stock options and dividend reinvestment plan	81	269	1,870	(95)		2,044
Stock issued for non- vested restricted stock	48	160	994	(1,154)		

Cash dividends, $0.65 per share				(9,534)		(9,534)
Shares repurchased or cancelled	(34)	(112)	(867)	73		(906)
Balance September 30, 2014	14,704	$ 9,898	$ 36,711	$ 204,215	$ 622	$ 251,446

See accompanying notes to unaudited consolidated financial statements.

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows (Unaudited)

For the nine months ended September 30, 2014 and 2013

(In thousands)

	2014	2013
Operating activities:		
Net income	$ 26,100	$ 20,857
Adjustments to reconcile net income to net cash provided by operating activities:		
(Credit) provision for loan losses	(400)	4,975
Depreciation, amortization and accretion, net	4,769	4,940
Deferred income tax benefit	(306)	(1,229)
Loss on sale of securities available-for-sale	9	5
Gain on sales of mortgage loans held for sale	(1,139)	(2,333)
Origination of mortgage loans held for sale	(64,332)	(129,742)
Proceeds from sale of mortgage loans held for sale	63,159	142,293
Bank owned life insurance income	(699)	(771)
(Gain) loss on the disposal of premises and equipment	(30)	22
(Gain) loss on the sale of other real estate	(342)	366
Gain on acquisition		(449)
Stock compensation expense	1,459	1,473
Excess tax benefits from share-based compensation arrangements	(257)	(109)
Decrease in accrued interest receivable and other assets	1,107	3,677
Increase in accrued interest payable and other liabilities	2,049	4,498
Net cash provided by operating activities	31,147	48,473
Investing activities:		
Purchases of securities available-for-sale	(220,296)	(282,262)
Proceeds from sale of securities available-for-sale	7,732	701
Proceeds from maturities of securities available-for-sale	256,948	337,762
Net increase in loans	(66,748)	(95,157)
Purchases of premises and equipment	(1,517)	(1,807)
Proceeds from disposal of premises and equipment	344	
Acquisition, net of cash acquired		8,963
Proceeds from sale of foreclosed assets	4,768	3,102
Net cash used in investing activities	(18,769)	(28,698)
Financing activities:		
Net increase (decrease) in deposits	26,884	(19,677)
Net (decrease) increase in securities sold under agreements to repurchase and federal funds purchased	(34,659)	9,727
Proceeds from Federal Home Loan Bank advances	32,740	575
Repayments of Federal Home Loan Bank advances	(30,150)	(35)
Issuance of common stock for options and dividend reinvestment plan	1,445	1,260
Excess tax benefits from share-based compensation arrangements	257	109
Common stock repurchases	(564)	(315)
Cash dividends paid	(9,534)	(8,602)
Net cash used in financing activities	(13,581)	(16,958)
Net (decrease) increase in cash and cash equivalents	(1,203)	2,817
Cash and cash equivalents at beginning of period	70,770	67,703
Cash and cash equivalents at end of period	$ 69,567	$ 70,520
Supplemental cash flow information:		

Income tax payments	$	8,764	$	6,230
Cash paid for interest		4,063		6,984
Supplemental non-cash activity:				
Transfers from loans to other real estate owned	$	1,780	$	2,382

See accompanying notes to unaudited consolidated financial statements.

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all information and footnotes required by U.S. generally accepted accounting principles (US GAAP) for complete financial statements. The consolidated unaudited financial statements of Stock Yards Bancorp, Inc. (Bancorp) and its subsidiary reflect all adjustments (consisting only of adjustments of a normal recurring nature) which are, in the opinion of management, necessary for a fair presentation of financial condition and results of operations for the interim periods.

The unaudited consolidated financial statements include the accounts of Stock Yards Bancorp, Inc. and its wholly-owned subsidiary, Stock Yards Bank & Trust Company (Bank). Significant intercompany transactions and accounts have been eliminated in consolidation. In preparing the unaudited consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of related revenues and expenses during the reporting period. Actual results could differ from the aforementioned estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, valuation of other real estate owned, valuation of securities, income tax assets, and estimated liabilities and expense.

A description of other significant accounting policies is presented in the notes to the Consolidated Financial Statements for the year ended December 31, 2013 included in Stock Yards Bancorp, Inc. s Annual Report on Form 10-K. Certain reclassifications have been made in the prior year financial statements to conform to current year classifications. These reclassifications had no effect on Bancorp s total assets, liabilities, equity or net income.

Interim results for the three and nine month periods ended September 30, 2014 are not necessarily indicative of the results for the entire year.

Critical Accounting Policies

Management has identified the accounting policy related to the allowance and provision for loan losses as critical to the understanding of Bancorp s results of operations and discussed this conclusion with Bancorp s Audit Committee. Since the application of this policy requires significant management assumptions and estimates, it could result in materially different amounts to be reported if conditions or underlying circumstances were to change. Assumptions include many factors such as changes in borrowers financial condition which can change quickly or historical loss ratios related to certain loan portfolios which may or may not be indicative of future losses. To the extent that management s assumptions prove incorrect, the results from operations could be materially affected by a higher or lower provision for loan losses. The accounting policy related to the allowance for loan losses is applicable to the commercial banking segment of Bancorp.

The allowance for loan losses is management s estimate of probable losses in the loan portfolio. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

Prior to the third quarter of 2013, management measured the appropriateness of the allowance for loan losses in its entirety using (a) quantitative (historical loss rates) and qualitative factors (management adjustment factors); (b) specific allocations on impaired loans, and (c) an unallocated amount. The unallocated amount was evaluated on the loan portfolio in its entirety and was based on additional factors,

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such as national and local economic trends and conditions, changes in volume and severity of past due loans, volume of non-accrual loans, volume and severity of adversely classified or graded loans and other factors and trends that affect specific loans and categories of loans, such as a heightened risk in the commercial and industrial loan portfolios. Bancorp considered the sum of all allowance amounts derived as described above, including a reasonable unallocated allowance, as an indicator of the appropriate level of allowance for loan losses.

During the third quarter of 2013, Bancorp refined its allowance calculation to allocate the portion of allowance that was previously deemed to be unallocated based on management s determination of appropriate qualitative adjustments. This calculation includes specific allowance allocations for qualitative factors including, among other factors, (i) national and local economic conditions, (ii) the quality and experience of lending staff and management, (iii) changes in lending policies and procedures, (iv) changes in volume and severity of past due loans, classified loans and non-performing loans, (v) potential impact of any concentrations of credit, (vi) changes in the nature and terms of loans such as growth rates and utilization rates, (vii) changes in the value of underlying collateral for collateral-dependent loans, considering Bancorp s disposition bias, and (viii) the effect of other external factors such as the legal and regulatory environment. Bancorp may also consider other qualitative factors for additional allowance allocations, including changes in Bancorp s loan review process. Changes in the criteria used in this evaluation or the availability of new information could cause the allowance to be increased or decreased in future periods. In addition, bank regulatory agencies, as part of their examination process, may require adjustments to the allowance for loan losses based on their judgments and estimates.

Management has also identified the accounting policy related to accounting for income taxes as critical to the understanding of Bancorp s results of operations and discussed this conclusion with the Audit Committee of the Board of Directors. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity s financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in Bancorp s financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences, including the effects of periodic IRS and state agency examinations, could materially impact Bancorp s financial position and its results from operations.

(2) Acquisition

On April 30, 2013, Bancorp completed the acquisition of 100% of the outstanding shares of THE BANCorp, Inc. (Oldham), parent company of THE BANK Oldham County, Inc. As a result of the transaction, THE BANK Oldham County merged into Stock Yards Bank & Trust Company. Since the acquisition date, results of operations acquired in the Oldham transaction have been included in Bancorp s financial results.

The Oldham transaction has been accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration transferred were recorded at estimated fair value on the acquisition date. Assets acquired totaled approximately $146.0 million, including $39.8 million of loans. Liabilities assumed totaled $125.1 million, including $120.4 million of deposits. Fair value adjustments resulted in net assets acquired in excess of the consideration paid. Accordingly, a non-taxable gain of $449 thousand was recognized.

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The following table summarizes the consideration paid and the amounts of assets acquired and liabilities assumed, adjusted for fair value at the acquisition date.

[redacted]		
Purchase price:		
[redacted]		
Cash	$	8,297
[redacted]		
Total purchase price		20,495
[redacted]		
Identifiable assets:		
[redacted]		
Investment securities		81,827
[redacted]		
Premises and equipment		4,008
[redacted]		
Other assets		605
[redacted]		
[redacted]		
Deposits		120,435
[redacted]		
Other liabilities		1,857
[redacted]		
Net gain resulting from acquisition	$	449
[redacted]		
Acquisition costs (included in other non-interest expenses in Bancorp s income statement for the nine months ended September 30, 2013)	$	1,548

Fair value of the common shares issued as part of the consideration paid was determined based on the closing market price of Bancorp s common shares on the acquisition date.

Bancorp recorded a core deposit intangible of $2.5 million which is being amortized using methods that anticipate the life of the underlying deposits to which the intangible is attributable. At September 30, 2014, the unamortized core deposit intangible was $1.9 million. See Note 7 for details on the core deposit intangible.

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In many cases, determining the fair value of acquired assets and assumed liabilities required Bancorp to estimate cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest. The most significant of these determinations related to the valuation of acquired loans. Below is an analysis of the fair value of acquired loans as of September 30, 2014.

(in thousands)	Acquired impaired loans	Acquired non-impaired loans	Total acquired loans
Contractually required principal and interest at acquisition	$ 3,285	$ 37,763	$ 41,048
Contractual cash flows not expected to be collected	(372)	(723)	(1,095)
Expected cash flows at acquisition	2,913	37,040	39,953
Interest component of expected cash flows	(174)	(24)	(198)
Basis in acquired loans at acquisition - estimated fair value	$ 2,739	$ 37,016	$ 39,755

Fair values of checking, savings and money market deposit accounts acquired from Oldham were assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. Certificate of deposit accounts were valued at the present value of the certificates expected contractual payments discounted at market rates as of the acquisition date for similar certificates.

In connection with the Oldham acquisition, Bancorp incurred expenses related to executing the transaction and integrating and conforming acquired operations with and into Bancorp. Those expenses consisted largely of conversion of systems and/or integration of operations.

(3) Securities

The amortized cost, unrealized gains and losses, and fair value of securities available-for-sale follow:

(in thousands) September 30, 2014	Amortized cost	Unrealized Gains	Unrealized Losses	Fair value
Government sponsored enterprise obligations	$ 204,992	$ 1,535	$ 1,122	$ 205,405
Mortgage-backed securities - government agencies	180,890	1,379	2,419	179,850
Obligations of states and political subdivisions	61,616	1,808	65	63,359
Corporate equity securities	756	202		958
Total securities available-for-sale	$ 448,254	$ 4,924	$ 3,606	$ 449,572

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(in thousands) **December 31, 2013**	**Amortized cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair value**
U.S. Treasury and other U.S. government obligations	$ 110,000	$	$	$ 110,000
Government sponsored enterprise obligations	138,094	1,623	1,872	137,845
Mortgage-backed securities - government agencies	176,524	1,391	5,222	172,693
Obligations of states and political subdivisions	68,448	1,473	428	69,493
Total securities available-for-sale	$ 493,066	$ 4,487	$ 7,522	$ 490,031

There were no securities held-to-maturity as of September 30, 2014 or December 31, 2013.

Corporate equity securities, included in the available-for-sale portfolio at September 30, 2014, consist of common stock in a public-traded small business investment company.

In the second quarter of 2014, Bancorp sold securities with total fair market value of $7.7 million, generating a net loss of $9 thousand. These securities consisted of mortgage-backed securities with small remaining balances, obligations of state and political subdivisions, and agency securities. In the second quarter of 2013, Bancorp sold obligations of state and political subdivisions with total fair market value of $696 thousand, generating a loss of $5 thousand. These sales were made in the ordinary course of portfolio management. Management has the intent and ability to hold all remaining investment securities available-for-sale for the foreseeable future.

A summary of the available-for-sale investment securities by maturity groupings as of September 30, 2014 is shown below.

(in thousands) **Securities available-for-sale**	**Amortized cost**	**Fair value**
Due within 1 year	$ 52,895	$ 53,174
Due after 1 but within 5 years	131,963	133,441
Due after 5 but within 10 years	23,117	23,695
Due after 10 years	58,633	58,454
Mortgage-backed securities	180,890	179,850
Corporate equity securities	756	958
Total securities available-for-sale	$ 448,254	$ 449,572

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Actual maturities may differ from contractual maturities because some issuers have the right to call or prepay obligations. In addition to equity securities, the investment portfolio includes agency mortgage-backed securities, which are guaranteed by agencies such as the FHLMC, FNMA, and GNMA. These securities differ from traditional debt securities primarily in that they may have uncertain principal payment dates and are priced based on estimated prepayment rates on the underlying collateral.

Securities with a carrying value of approximately $209.2 million at September 30, 2014 and $243.5 million at December 31, 2013 were pledged to secure accounts of commercial depositors in cash management accounts, public deposits, and cash balances for certain investment management and trust accounts.

Securities with unrealized losses at September 30, 2014 and December 31, 2013, not recognized in the statements of income are as follows:

	Less than 12 months		12 months or more		Total	
(in thousands)	**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**
September 30, 2014						
Government sponsored enterprise obligations	$ 45,050	$ 163	$ 33,565	$ 959	$ 78,615	$ 1,122
Mortgage-backed securities - government agencies	45,123	445	45,133	1,974	90,256	2,419
Obligations of states and political subdivisions	1,924	12	6,341	53	8,265	65
Total temporarily impaired securities	$ 92,097	$ 620	$ 85,039	$ 2,986	$ 177,136	$ 3,606
December 31, 2013						
Government sponsored enterprise obligations	$ 76,755	$ 1,429	$ 4,353	$ 443	$ 81,108	$ 1,872
Mortgage-backed securities - government agencies	112,652	4,400	8,752	822	121,404	5,222
Obligations of states and political subdivisions	22,092	405	1,211	23	23,303	428
Total temporarily impaired securities	$ 211,499	$ 6,234	$ 14,316	$ 1,288	$ 225,815	$ 7,522

The applicable dates for determining when securities are in an unrealized loss position are September 30, 2014 and December 31, 2013. As such, it is possible that a security had a market value less than its amortized cost on other days during the past twelve months, but is not in the Investments with an unrealized loss of less than 12 months category above.

Unrealized losses on Bancorp s investment securities portfolio have not been recognized as expense because the securities are of high credit quality, and the decline in fair values is largely due to changes in the prevailing interest rate environment since the purchase date. Fair value is expected to recover as securities reach their maturity date and/or the interest rate environment returns to conditions similar to when these securities were purchased. These investments consist of 73 and 155 separate investment positions as of September 30, 2014 and December 31, 2013, respectively. Because management does not intend to sell the investments, and it is not likely that Bancorp will be required to sell the investments

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before recovery of their amortized cost bases, which may be maturity, Bancorp does not consider these securities to be other-than-temporarily impaired at September 30, 2014.

FHLB stock and other securities are investments held by Bancorp which are not readily marketable and are carried at cost. This category includes holdings of Federal Home Loan Bank of Cincinnati (FHLB) stock which are required for access to FHLB borrowing, and are classified as restricted securities. As of December 31, 2013, FHLB Stock and other securities included a $1 million Community Reinvestment Act (CRA) investment which matured in the second quarter of 2014.

(4) Loans

The composition of loans by primary loan portfolio segment follows:

(in thousands)	**September 30, 2014**	**December 31, 2013**
Commercial and industrial	$ 550,487	$ 510,739
Construction and development, excluding undeveloped land	93,964	99,719
Undeveloped land	27,177	29,871
Real estate mortgage	1,085,537	1,046,823
Consumer	28,155	34,198
Total loans	$ 1,785,320	$ 1,721,350

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The following table presents the balance in the recorded investment in loans and roll-forward of allowance for loan losses by portfolio segment and based on impairment evaluation method as of September 30, 2014 and December 31, 2013.

	Type of loan					
(in thousands) September 30, 2014	**Commercial and industrial**	**Construction and development excluding undeveloped land**	**Undeveloped land**	**Real estate mortgage**	**Consumer**	**Total**
Loans	$ 550,487	$ 93,964	$ 27,177	$ 1,085,537	$ 28,155	$ 1,785,320
Loans individually evaluated for impairment	$ 8,778	$ 516	$ 6,722	$ 4,207	$ 78	$ 20,301
Loans collectively evaluated for impairment	$ 541,626	$ 92,835	$ 20,455	$ 1,080,853	$ 28,065	$ 1,763,834
Loans acquired with deteriorated credit quality	$ 83	$ 613	$	$ 477	$ 12	$ 1,185

	Commercial and industrial	**Construction and development excluding undeveloped land**	**Undeveloped land**	**Real estate mortgage**	**Consumer**	**Unallocated**	**Total**
Allowance for loan losses							
At December 31, 2013	$ 7,644	$ 2,555	$ 5,376	$ 12,604	$ 343	$	$ 28,522
Provision (credit)	1,897	(1,011)	(4,294)	2,963	45		(400)
Charge-offs	(582)		(30)	(810)	(400)		(1,822)
Recoveries	211		166	98	349		824
At September 30, 2014	$ 9,170	$ 1,544	$ 1,218	$ 14,855	$ 337	$	$ 27,124
Allowance for loans individually evaluated for impairment	$ 1,559	$ 90	$	$ 432	$ 78	$	$ 2,159
Allowance for loans collectively evaluated for impairment	$ 7,611	$ 1,454	$ 1,218	$ 14,423	$ 259	$	$ 24,965
Balance: loans acquired with deteriorated credit quality	$	$	$	$	$	$	$

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(in thousands) December 31, 2013	Type of loan: Commercial and industrial	Construction and development excluding undeveloped land	Undeveloped land	Real estate mortgage	Consumer	Total
Loans	$ 510,739	$ 99,719	$ 29,871	$ 1,046,823	$ 34,198	$ 1,721,350
Loans individually evaluated for impairment	$ 7,579	$ 26	$ 7,340	$ 7,478	$ 84	$ 22,507
Loans collectively evaluated for impairment	$ 502,535	$ 98,428	$ 22,531	$ 1,038,824	$ 34,095	$ 1,696,413
Loans acquired with deteriorated credit quality	$ 625	$ 1,265	$	$ 521	$ 19	$ 2,430

	Commercial and industrial	Construction and development excluding undeveloped land	Undeveloped land	Real estate mortgage	Consumer	Unallocated	Total
Allowance for loan losses							
At December 31, 2012	$ 5,949	$ 1,638	$ 2,898	$ 14,288	$ 362	$ 6,746	$ 31,881
Provision	1,583	779	10,358	490	86	(6,746)	6,550
Charge-offs	(457)	(25)	(7,961)	(2,758)	(763)		(11,964)
Recoveries	569	163	81	584	658		2,055
At December 31, 2013	$ 7,644	$ 2,555	$ 5,376	$ 12,604	$ 343	$	$ 28,522
Allowance for loans individually evaluated for impairment	$ 762	$	$	$ 606	$ 84	$	$ 1,452
Allowance for loans collectively evaluated for impairment	$ 6,882	$ 2,555	$ 5,376	$ 11,998	$ 259	$	$ 27,070
Balance: loans acquired with deteriorated credit quality	$	$	$	$	$	$	$

Management uses the following portfolio segments of loans when assessing and monitoring the risk and performance of the loan portfolio:

- Commercial and industrial

- Construction and development, excluding undeveloped land
- Undeveloped land
- Real estate mortgage
- Consumer

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Bancorp has loans that were acquired in the Oldham acquisition, for which there was, at acquisition, evidence of deterioration of credit quality since origination and for which it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of those loans is included in the balance sheet amounts of loans at September 30, 2014 and December 31, 2013. Changes in the interest component of the fair value adjustment for acquired impaired loans for the year ended December 31, 2013 and the nine months ended September 30, 2014 are shown in the following table:

(in thousands)		
Balance at December 31, 2012	$	
Additions due to Oldham acquisition		174
Accretion		(37)
Reclassifications from (to) non-accretable difference		
Disposals		
Balance at December 31, 2013		137
Accretion		(61)
Reclassifications from (to) non-accretable difference		
Disposals		
Balance at September 30, 2014	$	76

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The following table presents loans individually evaluated for impairment as of September 30, 2014 and December 31, 2013.

(in thousands) **September 30, 2014**	**Recorded investment**	**Unpaid principal balance**	**Related allowance**	**Average recorded investment**
Loans with no related allowance recorded				
Commercial and industrial	$ 617	$ 761	$	$ 1,021
Construction and development, excluding undeveloped land	26	151		26
Undeveloped land	6,722	8,785		7,010
Real estate mortgage	2,308	2,773		3,048
Consumer				
Subtotal	9,673	12,470		11,105
Loans with an allowance recorded				
Commercial and industrial	$ 8,161	$ 8,636	$ 1,559	$ 6,911
Construction and development, excluding undeveloped land	490	490	90	123
Undeveloped land				
Real estate mortgage	1,899	1,899	432	2,264
Consumer	78	78	78	81
Subtotal	10,628	11,103	2,159	9,379
Total				
Commercial and industrial	$ 8,778	$ 9,397	$ 1,559	$ 7,932
Construction and development, excluding undeveloped land	516	641	90	149
Undeveloped land	6,722	8,785		7,010
Real estate mortgage	4,207	4,672	432	5,312
Consumer	78	78	78	81
Total	$ 20,301	$ 23,573	$ 2,159	$ 20,484

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(in thousands) December 31, 2013	Recorded investment	Unpaid principal balance	Related allowance	Average recorded investment
Loans with no related allowance recorded				
Commercial and industrial	$ 830	$ 974	$	$ 4,499
Construction and development, excluding undeveloped land	26	151		54
Undeveloped land	7,340	9,932		3,272
Real estate mortgage	3,731	5,069		5,559
Consumer				3
Subtotal	11,927	16,126		13,387
Loans with an allowance recorded				
Commercial and industrial	$ 6,749	$ 6,749	$ 762	$ 3,806
Construction and development, excluding undeveloped land				259
Undeveloped land				7,152
Real estate mortgage	3,747	4,065	606	3,705
Consumer	84	84	84	34
Subtotal	10,580	10,898	1,452	14,956
Total				
Commercial and industrial	$ 7,579	$ 7,723	$ 762	$ 8,305
Construction and development, excluding undeveloped land	26	151		313
Undeveloped land	7,340	9,932		10,424
Real estate mortgage	7,478	9,134	606	9,264
Consumer	84	84	84	37
Total	$ 22,507	$ 27,024	$ 1,452	$ 28,343

Differences between recorded investment amounts and unpaid principal balance amounts less related allowance are due to partial charge-offs which have occurred over the life of loans and fair value adjustments recorded for loans acquired.

Impaired loans include non-accrual loans and loans accounted for as troubled debt restructurings (TDR), which continue to accrue interest. Non-performing loans include the balance of impaired loans plus any loans over 90 days past due and still accruing interest. Loans past due more than 90 days or more and still accruing interest amounted to $207 thousand at September 30, 2014 and $437 thousand at December 31, 2013.

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The following table presents the recorded investment in non-accrual loans as of September 30, 2014 and December 31, 2013.

(in thousands)	**September 30, 2014**	**December 31, 2013**
Commercial and industrial	$ 2,825	$ 846
Construction and development, excluding undeveloped land	516	26
Undeveloped land	6,722	7,340
Real estate mortgage	3,782	7,046
Consumer		
Total	$ 13,845	$ 15,258

At September 30, 2014 and December 31, 2013, Bancorp had accruing loans classified as TDR of $6.5 million and $7.2 million, respectively.

Bancorp did not modify and classify any loans as TDR during the nine months ended September 30, 2014. The following table presents the recorded investment in loans modified and classified as TDR during the nine months ended September 30, 2013.

(dollars in thousands) **September 30, 2013**	**Number of contracts**	**Recorded investment**
Commercial & industrial	1	$ 796
Consumer	1	86
Total	2	$ 882

Bancorp did not have any loans accounted for as TDR that were restructured and experienced a payment default within the previous 12 months as of September 30, 2014. The following table presents the recorded investment in loans accounted for as TDR that were restructured and experienced a payment default within the previous 12 months as of September 30, 2013.

(dollars in thousands) **September 30, 2013**	**Number of contracts**	**Recorded investment**
Real estate mortgage	2	$ 2,426
Total	2	$ 2,426

Loans accounted for as TDR include modifications from original terms such as those due to bankruptcy proceedings, modifications of amortization periods or temporary suspension of principal payments due to customer financial difficulties. Loans accounted for as TDR, which have not defaulted, are individually evaluated for impairment and, at September 30, 2014, had a total allowance allocation of $706 thousand, compared to $942 thousand at December 31, 2013.

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At September 30, 2014, Bancorp had no outstanding commitments to lend additional funds for loans classified as TDR. At December 31, 2013, Bancorp had outstanding commitments to lend additional funds totaling $262 thousand for loans classified as TDR.

The following table presents the aging of loans as of September 30, 2014 and December 31, 2013.

(in thousands)	30-59 days past due	60-89 days past due	Greater than 90 days past due (includes non-accrual)	Total past due	Current	Total loans	Recorded investment > 90 days and accruing
September 30, 2014							
Commercial and industrial	$ 85	$ 276	$ 2,827	$ 3,188	$ 547,299	$ 550,487	$ 2
Construction and development, excluding undeveloped land		242	516	758	93,206	93,964	
Undeveloped land	87		6,722	6,809	20,368	27,177	
Real estate mortgage	3,514	730	3,986	8,230	1,077,307	1,085,537	205
Consumer	702	18		720	27,435	28,155	
Total	$ 4,388	$ 1,266	$ 14,051	$ 19,705	$ 1,765,615	$ 1,785,320	$ 207
December 31, 2013							
Commercial and industrial	$ 808	$ 201	$ 1,268	$ 2,277	$ 508,462	$ 510,739	$ 421
Construction and development, excluding undeveloped land	429		26	455	99,264	99,719	
Undeveloped land			7,340	7,340	22,531	29,871	
Real estate mortgage	4,529	1,180	7,062	12,771	1,034,052	1,046,823	16
Consumer	110			110	34,088	34,198	
Total	$ 5,876	$ 1,381	$ 15,696	$ 22,953	$ 1,698,397	$ 1,721,350	$ 437

Consistent with regulatory guidance, Bancorp categorizes loans into credit 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. Pass-rated loans included all risk-rated loans other than those classified as special mention, substandard, and doubtful, which are defined below:

- Special Mention: Loans classified as special mention have a potential weakness that deserves management s close attention. These potential weaknesses may result in deterioration of repayment prospects for the loan or of Bancorp 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 collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize repayment of the debt. They are characterized by the distinct possibility that Bancorp will sustain some loss if the deficiencies are not corrected.

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- Substandard non-performing: Loans classified as substandard non-performing have all the characteristics of substandard loans and have been placed on non-accrual status or have been accounted for as troubled debt restructurings.

- Doubtful: Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or repayment in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

As of September 30, 2014 and December 31, 2013, the internally assigned risk grades of loans by category were as follows:

(in thousands)	Commercial and industrial	Construction and development, excluding undeveloped land	Undeveloped land	Real estate mortgage	Consumer	Total
September 30, 2014						
Grade						
Pass	$ 525,362	$ 82,319	$ 19,761	$ 1,065,631	$ 27,999	$ 1,721,072
Special mention	6,039	5,137	533	12,679	78	24,466
Substandard	10,306	5,992	161	2,816		19,275
Substandard non-performing	8,780	516	6,722	4,411	78	20,507
Doubtful						
Total	$ 550,487	$ 93,964	$ 27,177	$ 1,085,537	$ 28,155	$ 1,785,320
December 31, 2013						
Grade						
Pass	$ 486,140	$ 87,896	$ 22,366	$ 1,014,216	$ 34,028	$ 1,644,646
Special mention	12,983	7,091		17,916	86	38,076
Substandard	3,616	4,706	165	7,197		15,684
Substandard non-performing	8,000	26	7,340	7,494	84	22,944
Doubtful						
Total	$ 510,739	$ 99,719	$ 29,871	$ 1,046,823	$ 34,198	$ 1,721,350

(5) Federal Home Loan Bank Advances

Bancorp had outstanding borrowings of $36.9 million at September 30, 2014, via seven separate fixed-rate advances. For two advances totaling $30 million, both of which are non-callable, interest payments are due monthly, with principal due at maturity. For the remaining advances totaling $6.9 million, principal and interest payments are due monthly based on an amortization schedule.

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The following is a summary of the contractual maturities and average effective rates of outstanding advances:

	September 30, 2014		December 31, 2013	
(In thousands)	**Advance**	**Fixed rate**	**Advance**	**Fixed rate**
2014	$ 10,000	0.21%	$ 10,000	0.21%
2015	20,000	3.34%	20,000	3.34%
2020	1,896	2.23%	1,931	2.23%
2021	514	2.12%	564	2.12%
2024	3,113	2.36%	408	2.40%
2028	1,396	1.47%	1,426	1.46%
	$ 36,919	2.26%	$ 34,329	2.26%

Advances from the FHLB are collateralized by certain commercial and residential real estate mortgage loans under a blanket mortgage collateral agreement and FHLB stock. Bancorp views the borrowings as an effective alternative to higher cost time deposits to fund loan growth. At September 30 2014, the amount of available credit from the FHLB totaled $422.9 million.

(6) Derivative Financial Instruments

Occasionally, Bancorp enters into free-standing interest rate swaps for the benefits of its commercial customers who desire to hedge their exposure to changing interest rates. Bancorp offsets its interest rate exposure on commercial customer transactions by entering into swap agreements with approved reputable independent counterparties with substantially matching terms. These undesignated derivative instruments are recognized on the consolidated balance sheet at fair value. Because of matching terms of offsetting contracts and the collateral provisions mitigating any non-performance risk, changes in fair value subsequent to initial recognition are expected to have an insignificant effect on earnings. Exchanges of cash flows related to the undesignated interest rate swap agreements for the first nine months of 2014 were offsetting and therefore had no net effect on Bancorp s earnings or cash flows.

Interest rate swap agreements derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments, and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Bancorp is exposed to credit-related losses in the event of nonperformance by the counterparties to these agreements. Bancorp mitigates the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail their obligations.

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At September 30, 2014 and December 31, 2013, Bancorp had outstanding undesignated interest rate swap contracts as follows:

	Receiving				Paying			
(dollar amounts in thousands)	**September 30, 2014**		**December 31, 2013**		**September 30, 2014**		**December 31, 2013**	
Notional amount	$	7,381	$	5,159	$	7,381	$	5,159
Weighted average maturity (years)		7.0		6.4		7.0		6.4
Fair value	$	(337)	$	(275)	$	337	$	275

In December 2013, Bancorp entered into an interest rate swap to hedge cash flows of a $10 million floating-rate FHLB borrowing. The interest rate swap involves exchange of Bancorp s floating rate interest payments for fixed rate swap payments on the underlying principal amount. This swap was designated, and qualified, for cash-flow hedge accounting. The term of the swap began December 6, 2013 and ends December 6, 2016. For derivative instruments that are designated and qualify as hedging instruments, the effective portion of gains or losses is reported as a component of other comprehensive income, and is subsequently reclassified into earnings as an adjustment to interest expense in periods in which the hedged forecasted transaction affects earnings. The following table details Bancorp s derivative position designated as a cash flow hedge, and the fair values as of September 30, 2014 and December 31, 2013:

(dollars in thousands)

Notional amount		**Maturity date**	**Receive (variable) index**	**Pay fixed swap rate**	**Fair value September 30, 2014**		**Fair value December 31, 2013**	
$	10,000	12/6/2016	US$3 Month LIBOR	0.715%	$	40	$	24

(7) Goodwill and Intangible Assets

US GAAP requires that goodwill and intangible assets with indefinite useful lives not be amortized, but instead be tested for impairment at least annually. Annual evaluations have resulted in no indication of impairment. Bancorp currently has goodwill in the amount of $682 thousand from the 1996 acquisition of an Indiana bank. This goodwill is assigned to the commercial banking segment of Bancorp.

Bancorp recorded a core deposit intangible totaling $2.5 million arising from the Oldham acquisition. Through the first quarter of 2014, this intangible asset was being amortized over a ten-year period using an accelerated method which anticipated the life of the underlying deposits to which the intangible asset is attributable. Bancorp reevaluated the deposits and determined that for money market, savings and interest bearing checking accounts, it is more appropriate to amortize the intangible asset using a straight line method over 15 years. This revision was applied prospectively beginning in the second quarter of 2014. At September 30, 2014, the unamortized core deposit intangible was $1.9 million.

Mortgage servicing rights (MSRs) are initially recognized at fair value when mortgage loans are sold and amortized in proportion to and over the period of estimated net servicing income, considering appropriate prepayment assumptions. MSRs are evaluated quarterly for impairment by comparing carrying value to fair value. The estimated fair values of MSRs at September 30, 2014 and December 31, 2013 were $3.5 million and $4.0 million, respectively. The total outstanding principal balances of loans serviced for others were $427.2 million and $435.3 million at September 30, 2014, and December 31, 2013, respectively.

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Changes in the net carrying amount of MSRs for the nine months ended September 30, 2014 and 2013 are shown in the following table:

(in thousands)	For nine months ended September 30, 2014	2013
Balance at beginning of period	$ 1,832	$ 2,088
Additions for mortgage loans sold	197	682
Amortization	(713)	(755)
Balance at September 30	$ 1,316	$ 2,015

(8) Defined Benefit Retirement Plan

Bancorp sponsors an unfunded, non-qualified, defined benefit retirement plan for four key officers (two current, and two retired), and has no plans to increase the number of participants. Benefits vest based on 25 years of service. The actuarially determined pension costs are expensed and accrued over the service period, and benefits are paid from Bancorp s assets. The net periodic benefits costs, which include interest cost and amortization of net losses, totaled $32 thousand and $36 thousand, for the three months ended September 30, 2014 and 2013, respectively. For the nine months ended September 30, 2014 and 2013, the net periodic benefit costs totaled $95 thousand and $107 thousand, respectively.

(9) Commitments and Contingent Liabilities

As of September 30, 2014, Bancorp had various commitments outstanding that arose in the normal course of business, including standby letters of credit and commitments to extend credit, which are properly not reflected in the consolidated financial statements. In management s opinion, commitments to extend credit of $479.4 million including standby letters of credit of $11.7 million represent normal banking transactions, and no significant losses are anticipated to result from these commitments as of September 30, 2014. Commitments to extend credit were $464.2 million, including letters of credit of $15.2 million, as of December 31, 2013. Bancorp s maximum exposure to credit loss in the event of nonperformance by the other party to these commitments is represented by the contractual amount of these instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. Commitments to extend credit are mainly comprised of commercial lines of credit, construction and home equity credit lines. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Bancorp uses the same credit and collateral policies in making commitments and conditional guarantees as for on-balance sheet instruments. Bancorp evaluates each customer s creditworthiness on a case by case basis. The amount of collateral obtained is based on management s credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, equipment, and real estate.

Standby letters of credit and financial guarantees written are conditional commitments issued by Bancorp to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private commercial transactions. Standby letters of credit generally have maturities of one to two years.

To provide service to commercial accounts, Bancorp aids customers with letters of credits or other financial contracts with other financial institutions. Accordingly, Bancorp has entered into agreements to

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guarantee performance of several customers contracts with other financial institutions. Bancorp will make payments under these agreements if a customer defaults on its obligations to the other financial institutions. The terms of the agreements range from 1 to 22 months. The maximum potential future payment guaranteed by Bancorp at September 30, 2014 was $4.4 million. If an event of default on all contracts had occurred at September 30, 2014, Bancorp would have been required to make payments of approximately $2.9 million. No payments have ever been required as a result of default on these contracts. These agreements are normally secured by collateral acceptable to Bancorp, which limits credit risk associated with the agreements.

Also, as of September 30, 2014, in the normal course of business, there were pending legal actions and proceedings in which claims for damages are asserted. Management, after discussion with legal counsel, believes the ultimate result of these legal actions and proceedings will not have a material adverse effect on the consolidated financial position or results of operations of Bancorp.

(10) Preferred Stock

Bancorp has a class of preferred stock (no par value; 1,000,000 shares authorized), the relative rights, preferences and other terms of which or any series within the class will be determined by the Board of Directors prior to any issuance. None of this stock has been issued to date.

(11) Stock-Based Compensation

The fair value of all awards granted, net of estimated forfeitures, is recognized as compensation expense over the respective service period.

Bancorp currently has one stock-based compensation plan. Initially, in the 2005 Stock Incentive Plan, there were 735,000 shares of common stock reserved for issuance of stock based awards. In 2010, shareholders approved an additional 700,000 shares of common stock for issuance under the plan. As of September 30, 2014, there were 449,428 shares available for future awards. Bancorp s 1995 Stock Incentive Plan expired in 2005; however, options granted under this plan expire as late as 2015.

Options and stock appreciation rights (SARs) granted generally have a vesting schedule of 20% per year. Options and SARs expire ten years after the grant date unless forfeited due to employment termination. No stock options have been granted since 2007.

Restricted shares granted to officers generally vest over five years. All restricted shares have been granted at a price equal to the market value of common stock at the time of grant. Because grantees are entitled to dividend payments during the performance period, the fair value of these restricted shares is equal to the market value of the shares on the date of grant.

Grants of performance stock units (PSUs) to executive officers vest based upon service and a single three-year performance period which begins January 1 of the first year of the performance period. Because grantees are not entitled to dividend payments during the performance period, the fair value of these PSUs is estimated based upon the fair value of the underlying shares on the date of grant, adjusted for non-payment of dividends.

Grants of restricted stock units (RSUs) to directors are time-based and vest based upon one year of service. Because grantees are entitled to deferred dividend payments at the end of the vesting period, the fair value of the RSUs are estimated based on the fair value of the underlying shares on the date of grant.

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Bancorp has recognized stock-based compensation expense, within salaries and employee benefits for employees, and within other non-interest expense for directors, in the consolidated statements of income as follows:

(in thousands)	For three months ended September 30, 2014	2013	For nine months ended September 30, 2014	2013
Stock-based compensation expense before income taxes	$ 691	$ 488	$ 1,459	$ 1,473
Less: deferred tax benefit	(242)	(171)	(510)	(516)
Reduction of net income	$ 449	$ 317	$ 949	$ 957

Bancorp expects to record an additional $499 thousand of stock-based compensation expense in 2014 for equity grants outstanding as of September 30, 2014. As of September 30, 2014, Bancorp has $3.7 million of unrecognized stock-based compensation expense that is expected to be recorded as compensation expense over the next five years as awards vest. Bancorp received cash of $1.4 million and $1.3 million from the exercise of options during the first nine months of 2014 and 2013, respectively.

The fair values of Bancorp s stock options and SARs are estimated at the date of grant using the Black-Scholes option pricing model, a leading formula for calculating the value of stock options and SARs. This model requires the input of subjective assumptions, changes to which can materially affect the fair value estimate. The fair value of restricted shares is determined by Bancorp s closing stock price on the date of grant. The following assumptions were used in SAR valuations at the grant date in each year:

	2014	2013
Dividend yield	2.94%	2.80%
Expected volatility	23.66%	22.54%
Risk free interest rate	2.22%	1.26%
Expected life of SARs	7.0 years	6.6 years

Dividend yield and expected volatility are based on historical information corresponding to the expected life of options and SARs granted. Expected volatility is the volatility of the underlying shares for the expected term on a monthly basis. The risk free interest rate is the implied yield currently available on U.S. Treasury issues with a remaining term equal to the expected life of the options. The expected life of SARs is based on actual experience of past like-term options. Bancorp evaluates historical exercise and post-vesting termination behavior when determining the expected life.

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A summary of stock option and SARs activity and related information for the nine months ended September 30, 2014 follows:

	Options and SARs (in thousands)	Exercise price	Weighted average exercise price	Aggregate intrinsic value (in thousands)	Weighted average fair value	Weighted average remaining contractual life (in years)
At December 31, 2013						
Vested and exercisable	579	$ 20.25-26.83	$ 23.83	$ 4,685	$ 5.43	3.4
Unvested	218	21.03-24.87	22.70	2,011	4.36	7.7
Total outstanding	797	20.25-26.83	23.52	6,696	5.14	4.6
Granted	62	29.05-29.16	29.05	65	5.37	
Exercised	(89)	20.25-26.83	22.94	656	5.23	
Forfeited	(6)	21.03-23.76	22.78	46	4.43	
At September 30, 2014						
Vested and exercisable	570	20.90-26.83	23.79	3,601	5.35	3.5
Unvested	194	21.03-29.16	24.83	1,022	4.57	8.0
Total outstanding	764	20.90-29.16	24.05	$ 4,623	5.15	4.6
Vested year-to-date	80	$ 21.03-24.87	$ 22.49	$ 611	$ 4.63	

Intrinsic value for stock options and SARs is defined as the amount by which the current market price of the underlying stock exceeds the exercise or grant price.

For the periods ending December 31, 2013 and September 30, 2014, Bancorp granted shares of restricted common stock as outlined in the following table:

	Number	Grant date weighted-average cost
Unvested at December 31, 2012	113,910	$ 22.55
Shares awarded	55,275	22.93
Restrictions lapsed and shares released to employees/directors	(39,909)	22.29
Shares forfeited	(4,720)	23.45
Unvested at December 31, 2013	124,556	$ 22.77
Shares awarded	39,730	29.12
Restrictions lapsed and shares released to employees/directors	(44,724)	22.69
Shares forfeited	(3,164)	23.29
Unvested at September 30, 2014	116,398	$ 24.95

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Bancorp awarded PSUs to executive officers of Bancorp, the single three-year performance period for which began January 1 of the award year. The following table outlines the PSU grants.

Grant year	Vesting period in years	Fair value at grant date	Expected shares to be awarded
2012	3	20.57	28,079
2013	3	20.38	36,792
2014	3	26.42	16,675

In the first quarter of 2014, Bancorp awarded 3,920 RSUs to directors of Bancorp.

(12) Net Income Per Share

The following table reflects, for the three and nine months ended September 30, 2014 and 2013, net income (the numerator) and average shares outstanding (the denominator) for the basic and diluted net income per share computations:

	Three months ended September 30		Nine months ended September 30	
(In thousands, except per share data)	**2014**	**2013**	**2014**	**2013**
Net income	$ 9,889	$ 7,682	$ 26,100	$ 20,857
Average shares outstanding	14,574	14,408	14,542	14,144
Dilutive securities	174	148	190	84
Average shares outstanding including dilutive securities	14,748	14,556	14,732	14,228
Net income per share, basic	$ 0.68	$ 0.53	$ 1.79	$ 1.47
Net income per share, diluted	$ 0.67	$ 0.53	$ 1.77	$ 1.47

(13) Segments

Bancorp s principal activities include commercial banking and investment management and trust. Commercial banking provides a full range of loan and deposit products to individual consumers and businesses. Commercial banking also includes Bancorp s mortgage origination and securities brokerage activity. Investment management and trust provides wealth management services including investment management, trust and estate administration, and retirement plan services.

Financial information for each business segment reflects that which is specifically identifiable or allocated based on an internal allocation method. Income taxes are allocated based on the effective federal income tax rate adjusted for any tax exempt activity. All tax exempt activity and provision for loan losses have been allocated to the commercial banking segment. The measurement of the performance of the business

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segments is based on the management structure of Bancorp and is not necessarily comparable with similar information for any other financial institution. Information presented is also not necessarily indicative of the segments operations if they were independent entities.

Selected financial information by business segment for the three and nine month periods ended September 30, 2014 and 2013 follows:

(in thousands)	Commercial banking	Investment management and trust	Total
Three months ended September 30, 2014			
Net interest income	$ 21,317	$ 46	$ 21,363
(Credit) provision for loan losses	(2,100)		(2,100)
Investment management and trust services		4,502	4,502
All other non-interest income	5,348		5,348
Non-interest expense	15,971	2,738	18,709
Income before income taxes	12,794	1,810	14,604
Tax expense	4,071	644	4,715
Net income	$ 8,723	$ 1,166	$ 9,889
Three months ended September 30, 2013			
Net interest income	$ 19,978	$ 39	$ 20,017
Provision for loan losses	1,325		1,325
Investment management and trust services		4,017	4,017
All other non-interest income	5,621	14	5,635
Non-interest expense	15,215	2,356	17,571
Income before income taxes	9,059	1,714	10,773
Tax expense	2,485	606	3,091
Net income	$ 6,574	$ 1,108	$ 7,682

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(in thousands)	Commercial banking	Investment management and trust	Total
Nine months ended September 30, 2014			
Net interest income	$ 62,110	$ 136	$ 62,246
(Credit) provision for loan losses	(400)		(400)
Investment management and trust services		13,825	13,825
All other non-interest income	15,527	30	15,557
Non-interest expense	46,036	7,918	53,954
Income before income taxes	32,001	6,073	38,074
Tax expense	9,814	2,160	11,974
Net income	$ 22,187	$ 3,913	$ 26,100
Nine months ended September 30, 2013			
Net interest income	$ 57,347	$ 108	$ 57,455
Provision for loan losses	4,975		4,975
Investment management and trust services		12,032	12,032
All other non-interest income	17,114	45	17,159
Non-interest expense	45,176	6,796	51,972
Income before income taxes	24,310	5,389	29,699
Tax expense	6,938	1,904	8,842
Net income	$ 17,372	$ 3,485	$ 20,857

(14) Income Taxes

An analysis of the difference between the statutory and effective tax rates for the nine months ended September 30, 2014 and 2013 follows:

	Nine months ended September 30 2014	2013
U.S. federal statutory tax rate	35.0%	35.0%
Tax exempt interest income	(1.5)	(2.0)
Tax credits	(1.5)	(2.2)
Cash surrender value of life insurance	(1.3)	(1.8)
State income taxes	0.9	0.7
Other, net	(0.2)	0.1
Effective tax rate	31.4%	29.8%

US GAAP provides guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns. As of September 30, 2014 and December 31, 2013, the gross amount of unrecognized tax benefits was $37 thousand and $41 thousand, respectively. If recognized, the tax benefits would reduce tax expense and accordingly, increase net income. The amount of unrecognized tax benefits may increase or decrease in the future for various reasons including adding amounts for current tax year positions, expiration of open income tax returns due to statutes of limitation, changes in management s judgment about the level of uncertainty, status of examination, litigation and legislative activity and the addition or elimination of uncertain tax positions.

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During the second quarter of 2014, the IRS completed the examination of Bancorp s 2011 corporate income tax return. There were no significant adjustments to taxable income. Federal income tax returns are subject to examination for the years after 2011 and state income tax returns are subject to examination for the years after 2010.

Bancorp s policy is to report interest and penalties, if any, related to unrecognized tax benefits in income tax expense. As of both September 30, 2014 and December 31, 2013, the amount accrued for the potential payment of interest and penalties was $2 thousand.

(15) Fair Value Measurements

Bancorp follows the provisions of the authoritative guidance for fair value measurements. This guidance is definitional and disclosure oriented and addresses how companies should approach measuring fair value when required by US GAAP. The guidance also prescribes various disclosures about financial statement categories and amounts which are measured at fair value, if such disclosures are not already specified elsewhere in US GAAP.

The authoritative guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between participants at the measurement date. The guidance also establishes a hierarchy to group assets and liabilities carried at fair value in three levels based upon the markets in which the assets and liabilities trade and the reliability of assumptions used to determine fair value. These levels are:

- Level 1: Valuation is based upon quoted prices for identical instruments traded in active markets.

- Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

- Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions would reflect internal estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques could include pricing models, discounted cash flows and other similar techniques.

Authoritative guidance requires maximization of use of observable inputs and minimization of use of unobservable inputs in fair value measurements. Where there exists limited or no observable market data, Bancorp derives its own estimates by generally considering characteristics of the asset/liability, the current economic and competitive environment and other factors. For this reason, results cannot be determined with precision and may not be realized on an actual sale or immediate settlement of the asset or liability.

Bancorp s investment securities available-for-sale and interest rate swaps are recorded at fair value on a recurring basis. Other accounts including mortgage loans held for sale, mortgage servicing rights, impaired loans and other real estate owned may be recorded at fair value on a non-recurring basis, generally in the application of lower of cost or market adjustments or write-downs of specific assets.

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The portfolio of investment securities available-for-sale is comprised of U.S. Treasury and other U.S. government obligations, debt securities of U.S. government-sponsored corporations (including mortgage-backed securities), obligations of state and political subdivisions and corporate equity securities. Corporate equity securities, included in the 2014 table, are priced using quoted prices of identical securities in an active market. These measurements are classified as Level 1 in the hierarchy above. All other securities are priced using standard industry models or matrices with various assumptions such as yield curves, volatility, prepayment speeds, default rates, time value, credit rating and market prices for similar instruments. These assumptions are generally observable in the market place and can be derived from or supported by observable data. These measurements are classified as Level 2 in the hierarchy above.

Interest rate swaps are valued using primarily Level 2 inputs. Fair value measurements generally based on dealer quotes, benchmark forward yield curves, and other relevant observable market data. For purposes of potential valuation adjustments to derivative positions, Bancorp evaluates the credit risk of its counterparties as well as its own credit risk. To date, Bancorp has not realized any losses due to a counterparty s inability to perform and the change in value of derivative assets and liabilities attributable to credit risk was not significant during 2014.

Below are the carrying values of assets measured at fair value on a recurring basis.

	Fair value at September 30, 2014			
(in thousands)	**Total**	**Level 1**	**Level 2**	**Level 3**
Assets				
Investment securities available-for-sale				
Government sponsored enterprise obligations	$ 205,405	$	$ 205,405	$
Mortgage-backed securities - government agencies	179,850		179,850	
Obligations of states and political subdivisions	63,359		63,359	
Corporate equity securities	958	958		
Total investment securities available-for-sale	449,572	958	448,614	
Interest rate swaps	377		377	
Total assets	$ 449,949	$ 958	$ 448,991	$
Liabilities				
Interest rate swaps	$ 337	$	$ 337	$

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		Fair value at December 31, 2013	
(in thousands)	**Total**	**Level 1**	**Level 2**