

GERMAN AMERICAN BANCORP, INC.  
Form 10-Q  
November 09, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended September 30, 2006

Or

Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-11244

German American Bancorp, Inc  
(Exact name of registrant as specified in its charter)

Indiana  
(State or other jurisdiction of  
incorporation or organization)

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

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

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

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

YES  NO

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

Large Accelerated filer

Accelerated filer

Non-accelerated filer

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

YES  NO

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

| Class                      | Outstanding at November 1, 2006 |
|----------------------------|---------------------------------|
| Common Stock, no par value | 11,009,187                      |

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**CAUTION REGARDING FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS**

Information included in or incorporated by reference in this Quarterly Report on Form 10-Q, our other filings with the Securities and Exchange Commission (the “SEC”) and our press releases or other public statements, contains or may contain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Please refer to a discussion of our forward-looking statements and associated risks in Item 2 of Part I of this Report (“Management’s Discussion and Analysis of Financial Condition and Results of Operations”) at the conclusion of that Item 2 under the heading “Forward-Looking Statements and Associated Risks.”

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(unaudited, dollars in thousands except per share data)

|  | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| Cash and Due from Banks  | \$ 27,889             | \$ 27,644            |
| Federal Funds Sold and Other Short-term Investments  | 5,188                 | 5,287                |
| Cash and Cash Equivalents  | 33,077                | 32,931               |
| Interest-bearing Time Deposits with Banks  | 200                   | ---                  |
| Securities Available-for-Sale, at Fair Value   | 204,185               | 181,150              |
| Securities Held-to-Maturity, at Cost (Fair value of \$6,207 and \$8,811 on September 30, 2006 and December 31, 2005, respectively) | 6,135                 | 8,684                |
| Loans Held-for-Sale  | 2,800                 | 1,901                |
| Total Loans  | 740,787               | 653,074              |
| Less: Unearned Income  | (1,864)               | (1,118)              |
| Allowance for Loan Losses  | (9,111)               | (9,265)              |
| Loans, Net   | 729,812               | 642,691              |
| Stock in FHLB of Indianapolis and Other Restricted Stock, at Cost  | 11,942                | 14,095               |
| Premises, Furniture and Equipment, Net   | 23,207                | 20,233               |
| Other Real Estate  | 1,082                 | 506                  |
| Goodwill   | 9,372                 | 3,813                |
| Intangible Assets  | 3,184                 | 2,388                |
| Company Owned Life Insurance   | 21,374                | 19,067               |
| Accrued Interest Receivable and Other Assets   | 14,351                | 19,008               |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,060,721</b>   | <b>\$ 946,467</b>    |
| <b>LIABILITIES</b>   |                       |                      |
| Non-interest-bearing Demand Deposits   | \$ 129,536            | \$ 130,383           |
| Interest-bearing Demand, Savings, and Money Market Accounts  | 301,257               | 307,664              |
| Time Deposits  | 393,524               | 308,774              |
| Total Deposits   | 824,317               | 746,821              |
| FHLB Advances and Other Borrowings   | 132,464               | 105,394              |
| Accrued Interest Payable and Other Liabilities   | 12,931                | 11,997               |
| <b>TOTAL LIABILITIES</b>   | <b>969,712</b>        | <b>864,212</b>       |
| <b>SHAREHOLDERS' EQUITY</b>  |                       |                      |
| Preferred Stock, \$10 par value; 500,000 shares authorized, no shares issued   | ---                   | ---                  |
| Common Stock, no par value, \$1 stated value;  |                       |                      |

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|   |              |            |
|---|--------------|------------|
| 20,000,000 shares authorized                | 11,009       | 10,643     |
| Additional Paid-in Capital                  | 68,165       | 63,784     |
| Retained Earnings                           | 12,553       | 9,391      |
| Accumulated Other Comprehensive Loss        | (718)        | (1,563)    |
| TOTAL SHAREHOLDERS' EQUITY                  | 91,009       | 82,255     |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY  | \$ 1,060,721 | \$ 946,467 |
| End of period shares issued and outstanding | 11,009,187   | 10,643,514 |

See accompanying notes to consolidated financial statements.

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

|   | <b>Three Months Ended</b> |                 |
|---|---------------------------|-----------------|
|   | <b>September 30,</b>      |                 |
|   | <b>2006</b>               | <b>2005</b>     |
| <b>INTEREST INCOME</b>  |                           |                 |
| Interest and Fees on Loans                                      | \$ 13,799                 | \$ 10,514       |
| Interest on Federal Funds Sold and Other Short-term Investments | 105                       | 55              |
| Interest and Dividends on Securities:                           |                           |                 |
| Taxable   | 1,998                     | 1,484           |
| Non-taxable   | 472                       | 523             |
| <b>TOTAL INTEREST INCOME</b>                                    | <b>16,374</b>             | <b>12,576</b>   |
| <b>INTEREST EXPENSE</b>   |                           |                 |
| Interest on Deposits  | 5,586                     | 3,427           |
| Interest on FHLB Advances and Other Borrowings                  | 1,679                     | 1,168           |
| <b>TOTAL INTEREST EXPENSE</b>                                   | <b>7,265</b>              | <b>4,595</b>    |
| <b>NET INTEREST INCOME</b>                                      | <b>9,109</b>              | <b>7,981</b>    |
| Provision for Loan Losses                                       | 290                       | 552             |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>      | <b>8,819</b>              | <b>7,429</b>    |
| <b>NON-INTEREST INCOME</b>                                      |                           |                 |
| Trust and Investment Product Fees                               | 564                       | 514             |
| Service Charges on Deposit Accounts                             | 1,101                     | 1,009           |
| Insurance Revenues  | 1,116                     | 1,096           |
| Other Operating Income  | 523                       | 635             |
| Gain on Sales of Loans and Related Assets                       | 83                        | 234             |
| Gain / (Loss) on Sales of Securities                            | 951                       | ---             |
| <b>TOTAL NON-INTEREST INCOME</b>                                | <b>4,338</b>              | <b>3,488</b>    |
| <b>NON-INTEREST EXPENSE</b>                                     |                           |                 |
| Salaries and Employee Benefits                                  | 5,403                     | 4,465           |
| Occupancy Expense   | 700                       | 589             |
| Furniture and Equipment Expense                                 | 581                       | 474             |
| Data Processing Fees  | 451                       | 309             |
| Professional Fees   | 541                       | 335             |
| Advertising and Promotions                                      | 201                       | 171             |
| Supplies  | 162                       | 129             |
| Other Operating Expenses  | 1,192                     | 1,053           |
| <b>TOTAL NON-INTEREST EXPENSE</b>                               | <b>9,231</b>              | <b>7,525</b>    |
| Income before Income Taxes                                      | 3,926                     | 3,392           |
| Income Tax Expense  | 1,194                     | 921             |
| <b>NET INCOME</b>   | <b>\$ 2,732</b>           | <b>\$ 2,471</b> |

|   |    |       |    |       |
|---|----|-------|----|-------|
| <b>COMPREHENSIVE INCOME</b>                       | \$ | 3,850 | \$ | 2,289 |
| Earnings Per Share and Diluted Earnings Per Share | \$ | 0.25  | \$ | 0.23  |
| Dividends Per Share                               | \$ | 0.14  | \$ | 0.14  |

See accompanying notes to consolidated financial statements.



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

|   | Nine Months Ended<br>September 30, |               |
|---|------------------------------------|---------------|
|   | 2006                               | 2005          |
| <b>INTEREST INCOME</b>  |                                    |               |
| Interest and Fees on Loans                                      | \$ 38,994                          | \$ 30,502     |
| Interest on Federal Funds Sold and Other Short-term Investments | 367                                | 194           |
| Interest and Dividends on Securities:                           |                                    |               |
| Taxable   | 5,668                              | 4,389         |
| Non-taxable   | 1,470                              | 1,667         |
| <b>TOTAL INTEREST INCOME</b>                                    | <b>46,499</b>                      | <b>36,752</b> |
| <b>INTEREST EXPENSE</b>   |                                    |               |
| Interest on Deposits  | 15,136                             | 9,398         |
| Interest on FHLB Advances and Other Borrowings                  | 4,480                              | 3,399         |
| <b>TOTAL INTEREST EXPENSE</b>                                   | <b>19,616</b>                      | <b>12,797</b> |
| <b>NET INTEREST INCOME</b>                                      | <b>26,883</b>                      | <b>23,955</b> |
| Provision for Loan Losses                                       | 634                                | 1,725         |
| <b>NET INTEREST INCOME AFTER PROVISION<br/>FOR LOAN LOSSES</b>  | <b>26,249</b>                      | <b>22,230</b> |
| <b>NON-INTEREST INCOME</b>                                      |                                    |               |
| Trust and Investment Product Fees                               | 1,690                              | 1,586         |
| Service Charges on Deposit Accounts                             | 2,976                              | 2,776         |
| Insurance Revenues  | 3,646                              | 3,562         |
| Other Operating Income  | 1,747                              | 2,063         |
| Gain on Sales of Loans and Related Assets                       | 750                                | 699           |
| Gain / (Loss) on Sales of Securities                            | 951                                | ---           |
| <b>TOTAL NON-INTEREST INCOME</b>                                | <b>11,760</b>                      | <b>10,686</b> |
| <b>NON-INTEREST EXPENSE</b>                                     |                                    |               |
| Salaries and Employee Benefits                                  | 15,954                             | 13,592        |
| Occupancy Expense   | 2,034                              | 1,798         |
| Furniture and Equipment Expense                                 | 1,667                              | 1,489         |
| Data Processing Fees  | 1,269                              | 946           |
| Professional Fees   | 1,423                              | 1,246         |
| Advertising and Promotions                                      | 612                                | 492           |
| Supplies  | 428                                | 360           |
| Other Operating Expenses  | 3,661                              | 3,248         |
| <b>TOTAL NON-INTEREST EXPENSE</b>                               | <b>27,048</b>                      | <b>23,171</b> |
| Income before Income Taxes                                      | 10,961                             | 9,745         |
| Income Tax Expense  | 3,178                              | 2,455         |

|   |    |       |    |       |
|---|----|-------|----|-------|
| <b>NET INCOME</b>                                 | \$ | 7,783 | \$ | 7,290 |
| <b>COMPREHENSIVE INCOME</b>                       | \$ | 8,628 | \$ | 6,575 |
| Earnings Per Share and Diluted Earnings Per Share | \$ | 0.71  | \$ | 0.67  |
| Dividends Per Share                               | \$ | 0.42  | \$ | 0.42  |

See accompanying notes to consolidated financial statements.

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

|  | <b>Nine Months Ended<br/>September 30,</b> |              |
|--|--|--------------|
|  | <b>2006</b>                                | <b>2005</b>  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                |  |              |
| Net Income   | \$ 7,783                                   | \$ 7,290     |
| Adjustments to Reconcile Net Income to Net Cash from Operating Activities: |  |              |
| Net Amortization on Securities   | (82)                                       | 458          |
| Depreciation and Amortization  | 2,043                                      | 1,889        |
| Amortization and Impairment of Mortgage Servicing Rights                   | 271  | 193          |
| Loans Originated for Sale  | (43,203)                                   | (47,503)     |
| Proceeds from Sales of Loans Held-for-Sale                                 | 42,542                                     | 48,009       |
| Loss on Investment in Limited Partnership                                  | 164  | 52           |
| Provision for Loan Losses  | 634  | 1,725        |
| Gain on Sale of Loans and Mortgage Servicing Rights, Net                   | (749)                                      | (676)        |
| (Gain) on Securities, Net  | (951)                                      | ---          |
| Loss / (Gain) on Sale of Other Real Estate and Repossessed Assets          | 1  | (23)         |
| (Gain) on Disposition and Impairment of Premises and Equipment             | (13)                                       | (311)        |
| FHLB Stock Dividends   | ---  | (287)        |
| Increase in Cash Surrender Value of Company Owned Life Insurance           | (529)                                      | (369)        |
| Equity Based Compensation  | 233  | ---          |
| Change in Assets and Liabilities:  |  |              |
| Interest Receivable and Other Assets                                       | 1,271                                      | (1,572)      |
| Interest Payable and Other Liabilities                                     | 16   | (1,896)      |
| <b>Net Cash from Operating Activities</b>                                  | <b>9,431</b>                               | <b>6,979</b> |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                |  |              |
| Proceeds from Maturities of Securities Available-for-Sale                  | 34,327                                     | 40,241       |
| Proceeds from Sales of Securities Available-for-Sale                       | 13,001                                     | ---          |
| Purchase of Securities Available-for-Sale                                  | (62,006)                                   | (40,231)     |
| Proceeds from Maturities of Securities Held-to-Maturity                    | 2,558                                      | 4,012        |
| Proceeds from Redemption of Federal Home Loan Bank Stock                   | 2,541                                      | ---          |
| Purchase of Loans  | (16,474)                                   | (7,309)      |
| Proceeds from Sales of Loans   | 16,535                                     | 8,896        |
| Loans Made to Customers, Net of Payments Received                          | (41,901)                                   | 782          |
| Proceeds from Sales of Mortgage Servicing Rights                           | 3,554                                      | ---          |
| Proceeds from Sales of Other Real Estate                                   | 689  | 520          |
| Property and Equipment Expenditures  | (2,834)                                    | (1,359)      |
| Proceeds from the Sale of Property and Equipment                           | 291  | 445          |
| Acquire Banking Entities   | (4,111)                                    | ---          |
| <b>Net Cash from Investing Activities</b>                                  | <b>(53,830)</b>                            | <b>5,997</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                |  |              |
| Change in Deposits   | 30,053                                     | (38,735)     |
| Change in Short-term Borrowings  | 18,896                                     | 19,125       |

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|  |               |                 |
|--|---------------|-----------------|
| Advances of Long-term Debt                     | 6,500         | 17,500          |
| Repayments of Long-term Debt                   | (6,196)       | (20,956)        |
| Issuance of Common Stock                       | 18            | 47              |
| Purchase / Retire Common Stock                 | ---           | (1,261)         |
| Employee Stock Purchase Plan                   | (105)         | (63)            |
| Dividends Paid                                 | (4,621)       | (4,556)         |
| <b>Net Cash from Financing Activities</b>      | <b>44,545</b> | <b>(28,899)</b> |
| <b>Net Change in Cash and Cash Equivalents</b> | <b>146</b>    | <b>(15,923)</b> |
| Cash and Cash Equivalents at Beginning of Year | 32,931        | 47,666          |
| Cash and Cash Equivalents at End of Period     | \$ 33,077     | \$ 31,743       |

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2006**  
**(unaudited, dollars in thousands except per share data)**

**Note 1 - Basis of Presentation**

German American Bancorp, Inc. operates primarily in the banking industry. The accounting and reporting policies of German American Bancorp, Inc. and its subsidiaries conform to U.S. generally accepted accounting principles. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. All adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the periods reported have been included in the accompanying unaudited consolidated financial statements, and all such adjustments are of a normal recurring nature. It is suggested that these consolidated financial statements and notes be read in conjunction with the financial statements and notes thereto in the German American Bancorp, Inc. December 31, 2005 Annual Report on Form 10-K.

**Note 2 - Per Share Data**

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

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>September 30,</b>      |             |
| Earnings per Share:                         | <b>2006</b>               | <b>2005</b> |
| Net Income                                  | \$ 2,732                  | \$ 2,471    |
| Weighted Average Shares Outstanding         | 10,994,686                | 10,826,729  |
| Earnings per Share:                         | \$ 0.25                   | \$ 0.23     |
| Diluted Earnings per Share:                 |                           |             |
| Net Income                                  | \$ 2,732                  | \$ 2,471    |
| Weighted Average Shares Outstanding         | 10,994,686                | 10,826,729  |
| Potentially Dilutive Shares, Net            | 13,416                    | 5,957       |
| Diluted Weighted Average Shares Outstanding | 11,008,102                | 10,832,686  |
| Diluted Earnings per Share                  | \$ 0.25                   | \$ 0.23     |

Stock options for 332,142 and 352,793 shares of common stock were not considered in computing diluted earnings per share for the three months ended September 30, 2006 and 2005, respectively because they were anti-dilutive.

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

|                                     | <b>Nine Months Ended</b> |             |
|-------------------------------------|--------------------------|-------------|
|                                     | <b>September 30,</b>     |             |
| Earnings per Share:                 | <b>2006</b>              | <b>2005</b> |
| Net Income                          | \$ 7,783                 | \$ 7,290    |
| Weighted Average Shares Outstanding | 10,993,944               | 10,851,022  |

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|   |    |            |    |            |
|---|----|------------|----|------------|
| Earnings per Share:                         | \$ | 0.71       | \$ | 0.67       |
| Diluted Earnings per Share:                 |    |            |    |            |
| Net Income                                  | \$ | 7,783      | \$ | 7,290      |
| Weighted Average Shares Outstanding         |    | 10,993,944 |    | 10,851,022 |
| Potentially Dilutive Shares, Net            |    | 8,735      |    | 6,869      |
| Diluted Weighted Average Shares Outstanding |    | 11,002,679 |    | 10,857,891 |
| Diluted Earnings per Share                  | \$ | 0.71       | \$ | 0.67       |

Stock options for 343,142 and 338,755 shares of common stock were not considered in computing diluted earnings per share for the nine months ended September 30, 2006 and 2005, respectively because they were anti-dilutive.

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2006**  
**(unaudited, dollars in thousands except per share data)**

**Note 3 - Securities**

The fair values of Securities Available-for-Sale are as follows:

|   | September 30,<br>2006 | December 31,<br>2005 |
|---|-----------------------|----------------------|
| U.S. Treasury Securities and Obligations of U.S. Government Corporations and Agencies | \$ 43,153             | \$ 13,492            |
| Obligations of State and Political Subdivisions                                       | 21,826                | 23,527               |
| Asset-/Mortgage-backed Securities   | 131,904               | 125,844              |
| Corporate Securities  | ---                   | 500                  |
| Equity Securities   | 7,302                 | 17,787               |
| Total   | \$ 204,185            | \$ 181,150           |

As of September 30, 2006, net unrealized losses on the total securities available-for-sale portfolio totaled approximately \$735. As of December 31, 2005, net unrealized losses on the total securities available-for-sale portfolio totaled approximately \$2,008.

Securities are written down to fair value when a decline in fair value is not considered temporary. In estimating other-than-temporary losses, management considers the length of time and extent that fair value has been less than cost, the financial condition and near term prospects of the issuer, and the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value. The Company had the intent and ability to hold these securities for the foreseeable future, and the decline in fair value was largely due to changes in market interest rates, therefore, the Company does not consider these securities to be other-than-temporarily impaired.

The total carrying values and fair values of Securities Held-to-Maturity are as follows:

|   | Carrying<br>Value | Fair<br>Value |
|---|-------------------|---------------|
| <b>September 30, 2006:</b>                      |                   |               |
| Obligations of State and Political Subdivisions | \$ 6,135          | \$ 6,207      |
| <b>December 31, 2005:</b>                       |                   |               |
| Obligations of State and Political Subdivisions | \$ 8,684          | \$ 8,811      |

**Note 4 - Loans**

Total loans, as presented on the balance sheet, are comprised of the following classifications:

**September 30,      December 31,**

|                                 | <b>2006</b> | <b>2005</b> |
|---------------------------------|-------------|-------------|
| Commercial and Industrial Loans | \$ 388,556  | \$ 319,241  |
| Residential Mortgage Loans      | 114,463     | 102,891     |
| Consumer Loans                  | 132,932     | 129,587     |
| Agricultural Loans              | 104,836     | 101,355     |
| Total Loans                     | \$ 740,787  | \$ 653,074  |
| Less: Unearned Income           | (1,864)     | (1,118)     |
| Allowance for Loan Losses       | (9,111)     | (9,265)     |
| Loans, Net                      | \$ 729,812  | \$ 642,691  |



**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2006**  
**(unaudited, dollars in thousands except per share data)**

**Note 5 - Allowance for Loan Losses**

A summary of the activity in the allowance for loan losses follows:

|                                      | September 30,<br>2006 | September 30,<br>2005 |
|--------------------------------------|-----------------------|-----------------------|
| Balance at January 1                 | \$ 9,265              | \$ 8,801              |
| Allowance of Acquired Affiliate      | 484                   | ---                   |
| Provision for Loan Losses            | 634                   | 1,725                 |
| Recoveries of Prior Loan Losses      | 284                   | 311                   |
| Loan Losses Charged to the Allowance | (1,556)               | (1,467)               |
| Balance at September 30              | \$ 9,111              | \$ 9,370              |

**Note 6 - Segment Information**

The Company's operations include three primary segments: core banking, trust and investment advisory services, and insurance operations. The core banking segment involves attracting deposits from the general public and using such funds to originate consumer, commercial, commercial real estate, and residential mortgage loans, primarily in the Company's local markets. The core banking segment also involves the sale of residential mortgage loans in the secondary market and the operation of a title insurance company. During the second quarter of 2006, the Company sold its mortgage loan servicing rights portfolio and commenced selling all secondary market residential mortgage loans on a servicing released basis. The trust and investment advisory services segment involves providing trust, investment advisory, and brokerage services to customers. The insurance segment offers a full range of personal and corporate property and casualty insurance products, primarily in the affiliate banks' local markets.

The core banking segment is comprised by the Company's banking subsidiary, German American Bancorp, which operates through six community banking affiliates with 29 retail banking offices. Net interest income from loans and investments funded by deposits and borrowings is the primary revenue for the core-banking segment. The trust and investment advisory services segment's revenues are comprised primarily of fees generated by German American Financial Advisors & Trust Company ("GAFA"). These fees are derived by providing trust, investment advisory, and brokerage services to its customers. The insurance segment consists of German American Insurance, Inc., which provides a full line of personal and corporate insurance products as agent under five distinctive insurance agency names from five offices; and German American Reinsurance Company, Ltd. ("GARCL"), which reinsures credit insurance products sold by the Company's affiliate banks. Commissions derived from the sale of insurance products are the primary source of revenue for the insurance segment.

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

Other column below, along with amounts to eliminate transactions between segments.

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**Note 6 - Segment Information (continued)****Three Months Ended  
September 30, 2006**

|  | <b>Core<br/>Banking</b> | <b>Trust and<br/>Investment<br/>Advisory<br/>Services</b> | <b>Insurance</b> | <b>Holding<br/>Company<br/>and<br/>Other</b> | <b>Consolidated<br/>Totals</b> |
|--|-------------------------|---|------------------|--|--------------------------------|
| Net Interest Income                          | \$ 9,411                | \$ 26   | \$ 31            | \$ (359)                                     | \$ 9,109                       |
| Gain on Sales of Loans and<br>Related Assets | 83                      | ---   | ---              | ---  | 83                             |
| Net Gain / (Loss) on Securities              | 951                     | ---   | ---              | ---  | 951                            |
| Trust and Investment Product Fees            | 1                       | 585   | ---              | (22)   | 564                            |
| Insurance Revenues                           | 52                      | 3   | 1,076            | (15)   | 1,116                          |
| Noncash Items:                               |                         |   |                  |  |                                |
| Provision for Loan Losses                    | 290                     | ---   | ---              | ---  | 290                            |
| Provision for Income Taxes                   | 2,002                   | 37  | 84               | (929)  | 1,194                          |
| Segment Profit / (Loss)                      | 4,062                   | 51  | 89               | (1,470)                                      | 2,732                          |
| Segment Assets                               | 1,048,015               | 2,193   | 9,186            | 1,327  | 1,060,721                      |

**Three Months Ended  
September 30, 2005**

|  | <b>Core<br/>Banking</b> | <b>Trust and<br/>Investment<br/>Advisory<br/>Services</b> | <b>Insurance</b> | <b>Holding<br/>Company<br/>and<br/>Other</b> | <b>Consolidated<br/>Totals</b> |
|--|-------------------------|---|------------------|--|--------------------------------|
| Net Interest Income                          | \$ 8,198                | \$ 11   | \$ 11            | \$ (239)                                     | \$ 7,981                       |
| Gain on Sales of Loans and<br>Related Assets | 234                     | ---   | ---              | ---  | 234                            |
| Net Gain / (Loss) on Securities              | ---                     | ---   | ---              | ---  | ---                            |
| Trust and Investment Product Fees            | 1                       | 534   | ---              | (21)   | 514                            |
| Insurance Revenues                           | 46                      | 21  | 1,055            | (26)   | 1,096                          |
| Noncash Items:                               |                         |   |                  |  |                                |
| Provision for Loan Losses                    | (548)                   | ---   | ---              | 1,100  | 552                            |
| Provision for Income Taxes                   | 1,968                   | 56  | 51               | (1,154)                                      | 921                            |
| Segment Profit / (Loss)                      | 3,992                   | 86  | 97               | (1,704)                                      | 2,471                          |
| Segment Assets                               | 900,584                 | 2,238   | 7,123            | 7,930  | 917,875                        |

**Nine Months Ended  
September 30, 2006**

|  | <b>Core<br/>Banking</b> | <b>Trust and<br/>Investment<br/>Advisory<br/>Services</b> | <b>Insurance</b> | <b>Holding<br/>Company<br/>and<br/>Other</b> | <b>Consolidated<br/>Totals</b> |
|--|-------------------------|---|------------------|--|--------------------------------|
|--|-------------------------|---|------------------|--|--------------------------------|

|  |    |           |    |       |    |       |    |         |    |           |
|--|----|-----------|----|-------|----|-------|----|---------|----|-----------|
| Net Interest Income                          | \$ | 27,877    | \$ | 54    | \$ | 81    | \$ | (1,129) | \$ | 26,883    |
| Gain on Sales of Loans and<br>Related Assets |    | 750       |    | ---   |    | ---   |    | ---     |    | 750       |
| Net Gain / (Loss) on Securities              |    | 951       |    | ---   |    | ---   |    | ---     |    | 951       |
| Trust and Investment Product Fees            |    | 3         |    | 1,753 |    | ---   |    | (66)    |    | 1,690     |
| Insurance Revenues                           |    | 151       |    | 9     |    | 3,544 |    | (58)    |    | 3,646     |
| Noncash Items:                               |    |           |    |       |    |       |    |         |    |           |
| Provision for Loan Losses                    |    | 1,091     |    | ---   |    | ---   |    | (457)   |    | 634       |
| Provision for Income Taxes                   |    | 5,310     |    | 105   |    | 348   |    | (2,585) |    | 3,178     |
| Segment Profit / (Loss)                      |    | 11,361    |    | 151   |    | 540   |    | (4,269) |    | 7,783     |
| Segment Assets                               |    | 1,048,015 |    | 2,193 |    | 9,186 |    | 1,327   |    | 1,060,721 |

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**Note 6 - Segment Information (continued)****Nine Months Ended  
September 30, 2005**

|  | <b>Core<br/>Banking</b> | <b>Trust and<br/>Investment<br/>Advisory<br/>Services</b> | <b>Insurance</b> | <b>Holding<br/>Company<br/>and<br/>Other</b> | <b>Consolidated<br/>Totals</b> |
|--|-------------------------|---|------------------|--|--------------------------------|
| Net Interest Income                          | \$ 24,370               | \$ 28   | \$ 22            | \$ (465)                                     | \$ 23,955                      |
| Gain on Sales of Loans and<br>Related Assets | 699                     | ---   | ---              | ---  | 699                            |
| Net Gain / (Loss) on Securities              | ---                     | ---   | ---              | ---  | ---                            |
| Trust and Investment Product Fees            | 4                       | 1,645   | ---              | (63)   | 1,586                          |
| Insurance Revenues                           | 167                     | 28  | 3,423            | (56)   | 3,562                          |
| Noncash Items:                               |                         |   |                  |  |                                |
| Provision for Loan Losses                    | 625                     | ---   | ---              | 1,100  | 1,725                          |
| Provision for Income Taxes                   | 4,669                   | 101   | 245              | (2,560)                                      | 2,455                          |
| Segment Profit / (Loss)                      | 10,469                  | 153   | 385              | (3,717)                                      | 7,290                          |
| Segment Assets                               | 900,584                 | 2,238   | 7,123            | 7,930  | 917,875                        |

**Note 7 - Stock Repurchase Plan**

On April 26, 2001 the Company announced that its Board of Directors approved a stock repurchase program for up to 607,754 (as adjusted for subsequent stock dividends) of the outstanding Common Shares of the Company. Shares may be purchased from time to time in the open market and in large block privately negotiated transactions. The Company is not obligated to purchase any shares under the program, and the program may be discontinued at any time before the maximum number of shares specified by the program are purchased. As of September 30, 2006, the Company had purchased 334,965 (as adjusted for subsequent stock dividends) shares under the program. No shares were purchased under the plan during the nine months ended September 30, 2006.

**Note 8 - Equity Plans and Equity Based Compensation**

The Company maintains two equity incentive plans under which stock options, restricted stock, and other equity incentive awards can be granted. At September 30, 2006, the Company has reserved 620,144 shares of Common Stock (as adjusted for subsequent stock dividends and subject to further customary anti-dilution adjustments) for the purpose of issuance pursuant to outstanding and future grants of options, restricted stock, and other equity awards to officers, directors and other employees of the Company.

Options may be designated as "incentive stock options" under the Internal Revenue Code of 1986, or as nonqualified options. While the date after which options are first exercisable is determined by the Long-Term Incentive Award Committee (formerly known as the Stock Option Committee) of the Company or, in the case of options granted to directors, by the Board of Directors, no stock option may be exercised after ten years from the date of grant (twenty years in the case of nonqualified stock options). The exercise price of stock options granted pursuant to the Plans must

be no less than the fair market value of the Common Stock on the date of the grant.

The Plans authorize an optionee to pay the exercise price of options in cash or in common shares of the Company or in some combination of cash and common shares. An optionee may tender already-owned common shares to the Company in exercise of an option. The Company typically issues authorized but unissued common shares upon the exercise of options.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (“SFAS”) No. 123R, “Share Based Payment.” The Company elected to utilize the modified prospective transition method, therefore, prior period results have not been restated. Prior to the adoption of SFAS 123R, stock-based compensation expense related to stock options was not recognized in the results of operations if the exercise price was at least equal to the market value of the common stock on the grant date, in accordance with Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees.”

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**Note 8 - Equity Plans and Equity Based Compensation (continued)**

SFAS 123R requires all share-based payments to employees, including grants of employee stock options and grants of restricted shares, to be recognized as compensation expense over the service period (generally the vesting period) in the consolidated financial statements based on their fair values. For options with graded vesting, the Company values the stock option grants and recognizes compensation expense as if each vesting portion of the award was a single award. Under the modified prospective method, unvested awards, awards that are granted, modified, or settled on or after January 1, 2006 are measured and accounted for in accordance with SFAS 123R. The impact of forfeitures that may occur prior to vesting is also estimated and considered in the amount recognized.

**Stock Options**

On December 29, 2005, the Long-Term Incentive Award Committee of the Company approved the accelerated vesting of all currently outstanding unvested stock options awarded to recipients under its 1999 Long Term Equity Incentive Plan effective December 29, 2005. The decision to accelerate the vesting was made primarily to reduce non-cash compensation expense that the Company would have recorded in its income statement in future periods upon the adoption of SFAS 123R in January 2006. The Long-Term Incentive Award Committee believed it was in the best interest of the Company's shareholders to accelerate the vesting of these Options to eliminate compensation expense in future periods. This future expense was estimated to be \$143. As a result of the acceleration action, options to purchase up to 161,601 shares of common stock became exercisable immediately. Without the acceleration, the options would have vested on dates ranging from December 31, 2005 to August 29, 2010.

In conjunction with the acceleration of all vesting periods, the Long-Term Incentive Award Committee also took action to amend all outstanding options to eliminate any obligation to grant new options in replacement of shares tendered in payment of the exercise price of options, effective January 1, 2006. All other terms and conditions applicable to options, including the exercise prices and exercise periods, remain unchanged.

The following table summarizes stock option activity:

|                                    | <b>Nine Months Ended<br/>September 30, 2006</b> |   |
|------------------------------------|---|---|
|                                    | <b>Number<br/>Of Options</b>                    | <b>Weighted<br/>Average<br/>Price<br/>Per Share</b> |
| Outstanding at beginning of period | 405,019   | \$ 16.37  |
| Granted                            | 11,000  | 13.25   |
| Exercised                          | 12,663  | 12.58   |
| Forfeited                          | ---   | ---   |
| Expired                            | 21,109  | \$ 16.53  |
| Outstanding at end of period       | 382,247   | \$ 16.40  |





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**Note 8 - Equity Plans and Equity Based Compensation (continued)**

The following table details stock options outstanding :

|  | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|--|-------------------------------|------------------------------|
| <b>Stock Options vested and currently exercisable:</b> |                               |                              |
| Number of Options                                      | 382,247                       | 405,019                      |
| Weighted average exercise price                        | \$ 16.40                      | \$ 16.37                     |
| Weighted average remaining life (in years)             | 4.88                          | 5.04                         |
| Aggregate intrinsic value                              | \$ 57                         | \$ 22                        |

The intrinsic value for stock options is calculated based on the exercise price of the underlying awards and the market price of common stock as of the reporting date. The intrinsic value of options exercised was approximately \$5 for the nine months ended September 30, 2006. There were no options exercised during the third quarter 2006.

The Company recorded \$19 in stock compensation expense, net of an income tax benefit of \$10, during the nine months ended September 30, 2006 related to the granting of 11,000 options granted in the second quarter of 2006. To calculate the fair value of this option grant, the following assumptions were used as of the grant date: risk free interest rate 5.11%, expected option life 10.0 years, expected stock price volatility of 22.4%, and dividend yield of 4.20%. The resulting weighted average fair value of the options granted in the second quarter of 2006 was \$2.68 for each option granted. The Company recorded no other stock compensation expense applicable to options during the three and nine months ended September 30, 2006 because all outstanding options as of January 1, 2006 were fully vested prior to 2006.

The fair value of each stock option granted will be estimated on the date of grant using the Black-Scholes based stock option valuation model. This model requires the input of subjective assumptions that may have a significant impact on the fair value estimate. Expected volatility will be based on historical volatility of the Company's stock, and other factors. Expected dividends will be based on dividend trends and the market price of the Company's stock price at the time of the grant. The Company will use historical data to estimate option exercises and employee terminations within the valuation model. The risk-free rate for periods within the contractual life of the option will be based on the U.S. Treasury yield curve in effect at the time of the grant.

SFAS 123R requires the recognition of stock based compensation for the number of awards that are ultimately expected to vest. The Company did not reduce its compensation expense for estimated forfeitures prior to vesting because all grants made during the third quarter of 2006 were immediately vested. Estimated forfeitures will continue to be reassessed in future periods and may change based on new facts and circumstances.

As of September 30, 2006, there was no unrecognized option expense as all outstanding options were fully vested.

**Restricted Stock**

Effective February 15, 2006, the Long-Term Incentive Award Committee awarded a new type of long-term incentive award under one of its existing plans. In prior years, awards of long-term incentives were granted in the form of incentive stock options. The Long-Term Incentive Award Committee effective February 15, 2006 determined that future awards of long-term incentives under the plan should generally be made in the form of restricted stock, granted in tandem with cash credit entitlements. The incentive awards will typically be in the form of 50% restricted stock grants and 50% cash credit entitlements. The restricted stock grants and tandem cash credit entitlements are subject to forfeiture in the event that the recipient of the grant does not continue employment with the Company through December 15 of the year of grant, at which time they generally vest 100 percent. For measuring compensation costs, restricted stock awards are valued based upon the market value of the common shares on the date of grant.

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**Note 8 - Equity Plans and Equity Based Compensation (continued)**

The expense recorded for the restricted stock grants totaled \$35, net of an income tax benefit of \$23, and \$89, net of an income tax benefit of \$58, during the three and nine months ended September 30, 2006. Unrecognized expense associated with the restricted stock grants totaled \$41 as of September 30, 2006.

The following table presents information on restricted stock grants outstanding for the period shown:

|                                    | <b>Nine Months Ended<br/>September 30, 2006</b> |   |
|------------------------------------|---|---|
|                                    | <b>Restricted<br/>Shares</b>                    | <b>Weighted<br/>Average Market<br/>Price at Grant</b> |
| Outstanding at Beginning of Period | ---   | ---   |
| Granted                            | 14,501  | \$ 12.98  |
| Released                           | ---   | ---   |
| Forfeited                          | ---   | ---   |
| Outstanding at End of Period       | 14,501  | \$ 12.98  |

**Employee Stock Purchase Plan**

The Company maintains an Employee Stock Purchase Plan whereby eligible employees have the option to purchase the Company's common stock at a discount. The purchase price of the shares under this plan is determined annually and shall be in the range from 85% to 100% of the fair market value of such stock at either the beginning or end of the plan year. The plan provides for the purchase of up to 542,420 shares of common stock, which the Company may obtain by purchases on the open market or from private sources, or by issuing authorized but unissued common shares. Funding for the purchase of common stock is from employee and Company contributions. The plan was considered non-compensatory under APB No. 25, and as a result no compensation expense was recorded in periods prior to 2006 and Company contributions were a reduction to additional paid-in capital.

As a result of the adoption of SFAS 123R on January 1, 2006, the Company was required to record compensation expense for plan participation beginning January 1, 2006. The plan year for the Employee Stock Purchase Plan runs from August 17 through August 16 of the subsequent year. As of the beginning of the plan year, participants were granted the option to purchase Company stock at 85% of the lesser of the market value at the beginning or end of the plan year. The fair value of options granted as a part of plan was estimated on the date of grant similarly to those stock options granted under the Company's equity incentive plans utilizing a Black-Scholes stock option valuation model. The inputs for expected volatility, expected dividends, and risk-free rate are the same as previously discussed. The fair value of options granted was also affected by the estimate of employee participation in the plan, which is based upon historical experience. The grant date fair value of options granted for the plan year ending August 16, 2006 was estimated to be \$3.08. The grant date fair value of options granted for the plan year ending August 16, 2007 was estimated to be \$2.50. The expense recorded for the employee stock purchase plan totaled \$19 and \$58 during the three and nine months ended September 30, 2006. Unrecognized compensation expense as of September 30, 2006 totaled \$65 for the Employee Stock Purchase Plan.



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**Note 8 - Equity Plans and Equity Based Compensation (continued)**

The following table reflects the effect on net income and net income per share if the fair value based method had been applied to all outstanding and unvested stock options in 2005:

|   | <b>Three Months Ended<br/>September 30, 2005</b> |       |
|---|--|-------|
| Net Income as Reported  | \$   | 2,471 |
| Compensation Expense Under Fair Value Method, Net of Tax      |  | 37    |
| Pro forma Net Income  | \$   | 2,434 |
| Pro forma Earnings per Share and Diluted Earnings per Share   | \$   | 0.22  |
| Earnings per Share and Diluted Earnings per Share as Reported | \$   | 0.23  |

|   | <b>Nine Months Ended<br/>September 30, 2005</b> |       |
|---|---|-------|
| Net Income as Reported  | \$  | 7,290 |
| Compensation Expense Under Fair Value Method, Net of Tax      |   | 141   |
| Pro forma Net Income  | \$  | 7,149 |
| Pro forma Earnings per Share and Diluted Earnings per Share   | \$  | 0.66  |
| Earnings per Share and Diluted Earnings per Share as Reported | \$  | 0.67  |

**Note 9 - Employee Benefit Plans**

The Company acquired through previous bank mergers a noncontributory defined benefit pension plan with benefits based on years of service and compensation prior to retirement. The benefits under the plan were suspended in 1998. The following tables represent the components of net periodic benefit cost for the periods presented.

|                                      | <b>Three Months Ended<br/>September 30,</b> |             |        |
|--------------------------------------|---|-------------|--------|
|                                      | <b>2006</b>                                 | <b>2005</b> |        |
| Service Cost                         | \$  | ---         | \$ --- |
| Interest Cost                        |   | 12          | 12     |
| Expected Return on Assets            |   | (5)         | (6)    |
| Amortization of Transition Amount    |   | ---         | ---    |
| Amortization of Prior Service Cost   |   | ---         | ---    |
| Recognition of Net Loss              |   | 9           | 7      |
| Net Periodic Benefit Cost            | \$  | 16          | \$ 13  |
| Loss on Settlements and Curtailments |   | None        | None   |

|                                      | <b>Nine Months Ended<br/>September 30,</b> |      |             |      |
|--------------------------------------|--|------|-------------|------|
|                                      | <b>2006</b>                                |      | <b>2005</b> |      |
| Service Cost                         | \$   | ---  | \$          | ---  |
| Interest Cost                        |  | 37   |             | 37   |
| Expected Return on Assets            |  | (16) |             | (18) |
| Amortization of Transition Amount    |  | (1)  |             | (1)  |
| Amortization of Prior Service Cost   |  | (1)  |             | (2)  |
| Recognition of Net Loss              |  | 28   |             | 23   |
| Net Periodic Benefit Cost            | \$   | 47   | \$          | 39   |
| Loss on Settlements and Curtailments |  | None |             | None |

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**Note 9 - Employee Benefit Plans (continued)**

The Company previously disclosed in its financial statements for the year ended December 31, 2005, that it expected to contribute \$61 to the pension plan during the fiscal year ending December 31, 2006. As of September 30, 2006, the Company had contributed \$43 to the pension plan.

**Note 10 - Business Combinations**

On January 1, 2006, the Company consummated a merger with Stone City Bancshares, Inc. ("Stone City"). Stone City was merged with and into the Company, and Stone City's sole banking subsidiary, Stone City Bank of Bedford, Indiana, a state chartered banking institution operating two banking offices in Bedford, Indiana, became a subsidiary of the Company. Stone City's assets and equity as of December 31, 2005 totaled \$61.2 million and \$5.4 million, respectively. Net loss totaled \$332 for the year ended December 31, 2005. This net loss includes no provision for income taxes as Stone City had elected under Internal Revenue Service Code to be an S Corporation. As such, in lieu of corporate income taxes, the shareholders of Stone City were taxed on their proportionate share of the Company's taxable loss.

Under the terms of the merger, the shareholders of Stone City received aggregate cash payments of approximately \$6.4 million and 349,468 common shares of the Company valued at approximately \$4.6 million, representing a total transaction value of approximately \$11.0 million.

This merger was accounted for under the purchase method of accounting. The purchase resulted in approximately \$5.6 million in goodwill and \$1.3 million in core deposit intangible. The core deposit intangible is being amortized over 10 years. Goodwill will not be amortized but instead evaluated periodically for impairment. The Company is continuing to evaluate the purchase price allocation, with the allocation subject to refinement in subsequent periods.

Factors contributing to the purchase price include that this acquisition affords the Company the opportunity for an expansion of its geographic base to a growing market area immediately adjacent to its existing market area. The acquisition allowed the Company to expand its geographic footprint to the South Central Indiana markets of Bedford and Lawrence County providing the Company with an opportunity to market additional products and services to new customers and reduce operating costs through economies of scale.

**Note 11 - Contingencies**

Since December 31, 2001, the Company's effective tax rate has been favorably impacted by Indiana financial institution tax savings resulting from the Company's formation of investment subsidiaries in the state of Nevada by four of the Company's banking subsidiaries. The state of Nevada has no state or local income tax. During the first quarter of 2005, the Company received notices of proposed assessments of unpaid financial institutions tax for the years 2001 and 2002 of approximately \$691 (\$456 net of federal tax), including interest and penalties of approximately \$100. The Company filed a protest with the Indiana Department of Revenue contesting the proposed assessments and intends to vigorously defend its position that the income of the Nevada subsidiaries is not subject to the Indiana financial institutions tax. Although there can be no such assurance, at this time management does not believe it is probable that this potential assessment will result in additional tax liability. Therefore, no tax provision has been recognized for the potential assessment of additional financial institutions tax for 2001 and 2002 or for

financial institutions tax with respect to any of the Nevada subsidiaries in any period subsequent to 2002, including the nine-month period ended September 30, 2006.

**Note 12 - New Accounting Pronouncements**

FASB Interpretation No. 48 - In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 ("FIN 48"), which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company has not completed its evaluation of the impact of the adoption of FIN 48.



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**Note 12 - New Accounting Pronouncements (continued)**

FASB Staff Position 13-2 - In July 2006, the FASB issued FASB Staff Position (FSP) 13-2, Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction, which amends FASB Statement No. 13, Accounting for Leases. FSP 13-2 requires a lessor in a leveraged lease transaction to recalculate the leveraged lease for the effects of a change or projected change in the timing of cash flows relating to income taxes that are generated by the leveraged lease. FSP 13-2 is effective for fiscal years beginning after December 15, 2006. The Company has not completed its evaluation of the impact of the adoption of FSP 13-2.

SFAS No. 157 - In September 2006, the FASB issued Statement No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The new standard is effective for fiscal years beginning after November 15, 2007. The Company has not completed its evaluation of the impact of the adoption of SFAS No. 157.

SFAS No. 158 - In September 2006, the FASB issued Statement No. 158 - Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132(R). This Statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through comprehensive income. Defined benefit plan assets and obligations are to be measured as of the date of the employer's fiscal year-end. The employer must disclose in the notes to the financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of gains and losses, prior service costs or credits, and transition asset or obligation. The new standard is effective for employers with publicly traded equity securities as of the end of the fiscal year ending after December 15, 2006. The Company has not completed its evaluation of the impact of the adoption of SFAS No. 158.

SAB 108 - In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108) - Financial Statements - Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements. SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a potential current year misstatement. Prior to SAB 108, companies might evaluate the materiality of financial statement misstatements using either the income statement or balance sheet approach, with the income statement approach focusing on new misstatements added in the current year, and the balance sheet approach focusing on the cumulative amount of misstatement present in a company's balance sheet. Misstatements that would be material under one approach could be viewed as immaterial under another approach, and not be corrected. SAB 108 now requires that companies view financial statement misstatements as material if they are material according to either the income statement or balance sheet approach. This statement is effective as of the end of the fiscal year ending after December 15, 2006. The Company is currently evaluating the impact of adopting SAB 108 on the consolidated financial statements.

**Note 13 - Subsequent Events**

Effective October 1, 2006 the Company acquired substantially all of the assets, net of certain assumed liabilities of Keach and Grove Insurance, Inc. of Bedford, Indiana. The agency operations became a part of German American Insurance, Inc., the Company's property and casualty insurance entity.

The purchase price for this transaction was \$2.26 million in cash. It is anticipated that nearly the entire purchase price will be allocated to an amortizable customer relationship intangible resulting in minimal or no goodwill to be recognized from the acquisition. This customer relationship intangible is anticipated to be amortized to expense over seven years and deducted for tax purposes over 15 years using the straight line method. Amortization expense for the next five years is expected to be \$80,000 in 2006 and \$319,000 for each year thereafter. However, the Company is continuing to evaluate the purchase price allocation.

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

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

German American Bancorp, Inc. ("the Company") is a financial services holding company based in Jasper, Indiana. The Company's Common Stock is traded on NASDAQ's National Market System under the symbol GABC. The Company's banking subsidiary, German American Bancorp, operates through six community banking affiliates with 29 retail banking offices in the nine contiguous Southern Indiana counties of Daviess, Dubois, Gibson, Knox, Lawrence, Martin, Perry, Pike, and Spencer. The Company also operates a trust, brokerage and financial planning subsidiary which operates from the offices of the bank subsidiaries, and (giving effect to the October 1, 2006, acquisition of Keach and Grove Insurance, Inc. disclosed in Note 13 to the Consolidated Financial Statements included in this report) insurance agencies with six agency offices throughout its market area. The Company's lines of business include retail and commercial banking, mortgage banking, comprehensive financial planning, full service brokerage and trust administration, title insurance, and a full range of personal and corporate insurance products.

This section presents an analysis of the consolidated financial condition of the Company as of September 30, 2006 and December 31, 2005 and the consolidated results of operations for the three and nine months ended September 30, 2006 and 2005. This discussion should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein and with the financial statements and other financial data, as well as the Management's Discussion and Analysis of Financial Condition and Results of Operations, included in the Company's December 31, 2005 Annual Report on Form 10-K.

#### **MANAGEMENT OVERVIEW**

This updated discussion should be read in conjunction with the Management Overview that was included in our Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's December 31, 2005 Annual Report on Form 10-K.

Effective January 1, 2006, the Company completed the acquisition of Stone City Bancshares, Inc. which was in an adjacent market to its primary market area and effective October 1, 2005, the Company completed the in-market acquisition of PCB Holding Company. In addition to these acquisitions, during 2005 the Company invested in minority interests in two de novo financial institutions in larger markets that are within a 150 mile radius of the Company's primary market area. During the second quarter of 2006, the Company invested in a minority investment in a bank holding company that was newly formed by new management to acquire a small bank with an expressed intent to establish offices in Terre Haute and Lafayette, Indiana. Finally, effective October 1, 2006, the Company completed the acquisition of Keach and Grove Insurance, Inc. of Bedford, Indiana which was in the market of the Company's recent banking acquisition of Stone City Bancshares, Inc. This strategy of bank acquisitions and de novo investing along with the insurance agency acquisition has been undertaken to supplement organic growth within the Company's primary markets. Management expects to continue to pursue similar strategic acquisition and investing opportunities should opportunities become available.

The Company's level of net income increased approximately 11% and 7% during the three and nine months ended September 30, 2006 compared with the same periods of 2005. Current year earnings were positively affected by increases within the Company's net interest income and non-interest income as well as a reduced level of provision for loan losses. The improvement in the level of net-interest income was attributable to strong loan growth in both the third quarter and year-to-date. The increase in non-interest income was primarily credited to the gain derived from the

sale of the Company's portfolio of agency-issued preferred stock during the third quarter while the reduction in provision was due to improvements in the quality of the Company's loan portfolio. An offsetting factor to these positive earnings contributors was an increased level of non-interest related operating expenses due in large part to the inclusion of the banking acquisitions completed during the twelve months ended September 30, 2006.

Effective September 30, 2006, the Company combined the charters of its subsidiary banks into a single bank charter in order to simplify its corporate structure and better serve its customers, while retaining local direction of affiliate bank operations under the existing distinctive bank trade names in each of the markets served by the Company.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

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

### **Allowance for Loan Losses**

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

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

Commercial and agricultural loans are subject to a standardized grading process administered by an internal loan review function. The need for specific reserves is considered for credits when graded substandard or special mention, or when: (a) the customer's cash flow or net worth appears insufficient to repay the loan; (b) the loan has been criticized in a regulatory examination; (c) the loan is on non-accrual; or, (d) other reasons where the ultimate collectibility of the loan is in question, or the loan characteristics require special monitoring. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that we believe indicates the loan is impaired. Specific allocations on impaired loans are determined by comparing the loan balance to the present value of expected cash flows or expected collateral proceeds. Allocations are also applied to categories of loans not considered individually impaired but for which the rate of loss is expected to be greater than historical averages, including those graded substandard or special mention and non-performing consumer or residential real estate loans. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values.

General allocations are made for other pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a five-year historical average for loan losses for these portfolios, judgmentally 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 a minor unallocated component. The unallocated component of the allowance for loan losses incorporates the

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

### **Mortgage Servicing Rights Valuation**

Mortgage servicing rights (MSRs) were recognized and included with other assets for the allocated value of retained servicing rights on loans sold. Servicing rights were expensed in proportion to, and over the period of, estimated net servicing revenues. Impairment was evaluated based on the fair value of the rights, using groupings of the underlying loans as to type and age. Fair value was determined based upon discounted cash flows using market-based assumptions.

To determine the fair value of MSR's, the Company used a valuation model that calculated the present value of estimated future net servicing income. In using this valuation method, the Company incorporated assumptions that market participants would use in estimating future net servicing income, which included estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income.

The Company sold its mortgage servicing rights portfolio during the second quarter of 2006. Currently, all residential loans that are sold in the secondary market are sold on a servicing released basis.

### **Securities Available-for-Sale**

Securities classified as available-for-sale are securities that the Company intends to hold for an indefinite period of time, but not necessarily until maturity. Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported separately in accumulated other comprehensive income (loss), net of tax. The Company obtains market values from a third party on a monthly basis in order to adjust the securities to fair value. Additionally, securities available-for-sale are required to be written down to fair value when a decline in fair value is other than temporary; therefore, future changes in the fair value of securities could have a significant impact on the Company's operating results. In determining whether a market value decline is other than temporary, management considers the reason for the decline, the extent of the decline and the duration of the decline. As of September 30, 2006, gross unrealized losses on the securities available-for-sale portfolio totaled approximately \$2,499,000.

### **Income Tax Expense**

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

A valuation allowance reduces deferred tax assets to the amount management believes is more likely than not to be realized. In evaluating the realization of deferred tax assets, management considers the likelihood that sufficient taxable income of appropriate character will be generated within carryback and carryforward periods, including consideration of available tax planning strategies. As of December 31, 2005 the Company had a deferred tax asset of \$2.4 million representing various tax credit carryforwards. Based on the long carryforward periods available, management has assessed it more likely than not that these credits will be realized and no valuation allowance has been established on this asset.

Loss contingencies, including assessments arising from tax examinations and tax strategies, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. In considering the likelihood of loss, management considers the nature of the contingency, the progress of any examination or related protest or appeal, the opinions of legal counsel and other advisors, experience of the Company or other enterprises in similar matters, if any, and management's intended response to any assessment. During the first quarter of 2005, the Company received notices of proposed assessments of unpaid financial institutions tax for the years 2001 and 2002 of approximately \$691,000 (\$456,000 net of federal tax), including interest and penalties of approximately \$100,000. The Company filed a protest with the Indiana Department of Revenue contesting the proposed assessments and intends to vigorously defend its position that the income of the Nevada subsidiaries is not subject to the Indiana financial institutions tax. Although there can be no such assurance, at this time management does not believe that it is probable that this potential assessment will result in additional tax liability. Therefore, no tax provision has been recognized for the potential assessment of additional financial institutions tax for 2001 and 2002 or for financial institutions tax with respect to any of the Nevada subsidiaries in any period subsequent to 2002, including the nine-month period ended September 30, 2006.

## **RESULTS OF OPERATIONS**

### **Net Income:**

Net income increased \$261,000 or 11% to \$2,732,000 or \$0.25 per share for the quarter ended September 30, 2006 compared to \$2,471,000 or \$0.23 per share for the third quarter of 2005. The increase in net income during the third quarter of 2006 compared with 2005 was attributable principally to an increase in net interest income of \$1,128,000, a reduction in provision for loan losses of \$262,000, and a gain on the sale of the Company's portfolio of agency preferred stock of \$951,000, which were partially mitigated by an increase of \$1,706,000 in non-interest expense. The increases in net interest income and non-interest expenses were largely attributable to acquisitions of PCB Holding Company which was completed effective October 1, 2005 and Stone City Bancshares, Inc. which was completed effective January 1, 2006.



Net income increased \$493,000 or 7% to \$7,783,000 or \$0.71 per share for the nine months ended September 30, 2006 compared to \$7,290,000 or \$0.67 per share for the nine months ended September 30, 2005. The increase in net income during the first nine months of 2006 compared with 2005 was attributable principally to an increase in net interest income of \$2,928,000, a reduction in provision for loan losses of \$1,091,000, a gain on the sale of the Company's portfolio of agency preferred stock of \$951,000, which were partially mitigated by an increase of \$3,877,000 in non-interest expense. The increases in net interest income and non-interest expenses were largely attributable to acquisitions of PCB Holding Company and Stone City Bancshares, Inc.

### Net Interest Income:

Net interest income is the Company's single largest source of earnings, and represents the difference between interest and fees realized on earning assets, less interest paid on deposits and borrowed funds. The following table summarizes the Company's net interest income (on a tax-equivalent basis, at an effective tax rate of 34%) for each of the periods presented herein (dollars in thousands):

|                           | Three Months<br>Ended September 30, |           | Change from<br>Prior Period |         |
|---------------------------|-------------------------------------|-----------|-----------------------------|---------|
|                           | 2006                                | 2005      | Amount                      | Percent |
| Interest Income (T/E)     | \$ 16,647                           | \$ 12,872 | \$ 3,775                    | 29.3%   |
| Interest Expense          | 7,265                               | 4,595     | 2,670                       | 58.1%   |
| Net Interest Income (T/E) | \$ 9,382                            | \$ 8,277  | \$ 1,105                    | 13.4%   |

Net interest income increased \$1,128,000 or 14% (an increase of \$1,105,000 or 13% on a tax-equivalent basis) for the quarter ended September 30, 2006 compared with the same quarter of 2005. The increase in net interest income was primarily attributable to an increased level of average earning assets and an increased net interest margin in the quarter ended September 30, 2006 compared with 2005. The higher level of earning assets was primarily attributable to an increase in the average level of loans outstanding that resulted from new loan activity and from the acquisitions completed effective October 1, 2005 and effective January 1, 2006. Average earning assets totaled approximately \$948.2 million for the quarter ended September 30, 2006 compared with \$842.2 million for the quarter ended September 30, 2005.

The net interest margin represents tax-equivalent net interest income expressed as a percentage of average earning assets. For the third quarter of 2006, the net interest margin increased to 3.95% compared to 3.92% for the same period of 2005. The Company's yield on earning assets totaled 6.98% compared with a cost of funds (expressed as a percentage of average earning assets) of 3.03% producing the net interest margin of 3.95% for the three months ended September 30, 2006. The Company's yield on earning assets was 6.08% compared with a cost of funds of 2.16% netting to a net interest margin of 3.92% for the three months ended September 30, 2005.

|                           | Nine Months<br>Ended September 30, |           | Change from<br>Prior Period |         |
|---------------------------|------------------------------------|-----------|-----------------------------|---------|
|                           | 2006                               | 2005      | Amount                      | Percent |
| Interest Income (T/E)     | \$ 47,344                          | \$ 37,695 | \$ 9,649                    | 25.6%   |
| Interest Expense          | 19,616                             | 12,797    | 6,819                       | 53.3%   |
| Net Interest Income (T/E) | \$ 27,728                          | \$ 24,898 | \$ 2,830                    | 11.4%   |

Net interest income increased \$2,928,000 or 12% (an increase of \$2,830,000 or 11% on a tax-equivalent basis) for the nine months ended September 30, 2006 compared with the same period of 2005. The increase in net interest income was primarily attributable to an increased level of average earning assets and an increased net interest margin in the

nine months ended September 30, 2006 compared with 2005. The higher level of earning assets was primarily attributable to an increase in the average level of loans outstanding that resulted from new loan activity and from the previously discussed acquisitions completed effective October 1, 2005 and effective January 1, 2006. Average earning assets totaled \$929.5 million for the nine months ended September 30, 2006 compared with \$848.0 million for the same period of 2005.

For the first nine months of 2006, the net interest margin increased to 3.99% compared to 3.93% for the same period of 2005. The Company's yield on earning assets totaled 6.80% compared with a cost of funds (expressed as a percentage of average earning assets) of 2.81% producing the net interest margin of 3.99% for the nine months ended September 30, 2006. The Company's yield on earning assets was 5.94% compared with a cost of funds of 2.01% netting to a net interest margin of 3.93% for the nine months ended September 30, 2005.

#### **Provision for Loan Losses:**

The Company provides for loan losses through regular provisions to the allowance for loan losses. The provision is affected by net charge-offs on loans and changes in specific and general allocations of the allowance. Provisions for loan losses totaled \$290,000 during the quarter ended September 30, 2006 compared with \$552,000 in the third quarter of 2005. Provisions for loan losses totaled \$634,000 for the nine months ended September 30, 2006 compared with \$1,725,000 for the nine months ended September 30, 2005.

The Company's provision for loan losses declined during 2006 in conjunction with a decline in the Company's level of non-performing loans. In particular the Company reduced specific allocations on one large non-performing credit that was paid off during the second quarter of 2006. The Company recognized a charge-off of approximately \$393,000 on this individual credit facility, however the specific allocation as of year end 2005 was for considerably more than the level of charge-off. In addition to this reduction of specific allocation, the estimated losses associated with the previously identified non-performing loans (primarily placed on non-accrual status during the first half of 2005) was provided for in prior periods and to a significant degree during the first nine months of 2005. For further discussion of non-performing loans refer to "FINANCIAL CONDITION - Non-Performing Assets."

Net charge-offs totaled \$197,000 or 0.11% of average loans outstanding during the three months ended September 30, 2006 compared with \$683,000 or 0.43% of average loans outstanding during the same period of 2005. Net charge-offs totaled \$1,272,000 or 0.24% of average loans outstanding during the nine months ended September 30, 2006 compared with \$1,156,000 or 0.25% of average loans outstanding during the same period of 2005.

The provisions for loan losses made during the quarter ended September 30, 2006 were made at a level deemed necessary by management to absorb estimated, probable incurred losses in the loan portfolio. A detailed evaluation of the adequacy of the allowance for loan losses is completed quarterly by management, the results of which are used to determine provisions for loan losses. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors.

#### **Non-interest Income:**

Non-interest income increased \$850,000 or 24% and \$1,074,000 or 10% for the three and nine month periods ended September 30, 2006 as compared to the same periods of 2005. The increases in both the three and nine months ended September 30, 2006 was primarily attributable to the sale of the Company's portfolio of Federal Home loan Mortgage Corporation and Federal National Mortgage Corporation preferred stock during the third quarter of 2006. The gain from the sale of this agency preferred stock portfolio totaled \$951,000. The portfolio had a book value at the time of the sale of approximately \$12.1 million. The Company had previously recorded a non-cash other-than-temporary impairment charge of \$3.7 million on this portfolio during 2004.

Net Gains on Sales of Loans and Related Assets decreased \$151,000 or 65% and increased \$51,000 or 7% during the three and nine months ended September 30, 2006 compared with the same periods during 2005. The decline during the third quarter of 2006 compared with the prior year was largely due to a reduced level of sales of residential mortgage loans and a lower margin on those loans sold in the secondary market.

The increase, tempered by a reduced level of residential mortgage loans sales, during the nine months ended September 30, 2006 was largely due to the sale of the Company's mortgage servicing rights portfolio during the second quarter of 2006. The Company sold its mortgage servicing rights relating to approximately \$344.5 million of mortgage loans serviced for others for a total sales price of \$3.6 million resulting in a net gain of \$198,000.

Insurance revenues are expected to increase in future periods as a result of the acquisition of Keach and Grove Insurance, Inc., effective October 1, 2006, as disclosed in Note 13 to the accompanying Consolidated Financial Statements. Keach and Grove Insurance, Inc., is expected (assuming that attrition of client accounts as a result of the acquisition or other factors is not excessive) to contribute annualized commission revenues to the Company of approximately \$1.1 million.

Other Operating Income decreased by \$112,000 or 18% and \$316,000 or 15% for the quarter ended and nine months ended September 30, 2006 as compared with the same periods of the prior year. The decrease in the third quarter of 2006 compared with 2005 was largely attributable to a recovery of mortgage servicing rights impairment charges in the third quarter of 2005 of \$197,000. The decline for the nine months ended September 30, 2006 was predominately due to a gain on the sale of a former branch facility of approximately \$306,000 that was recorded during the second quarter of 2005 and a recovery of mortgage servicing rights impairment charges of \$333,000 during the first nine months of 2005. These declines in 2006 were partially offset by increased levels of other operating income resulting from the acquisitions completed effective October 1, 2005 and January 1, 2006.

#### **Non-interest Expense:**

Non-interest Expense increased \$1,706,000 or 23% and \$3,877,000 or 17% during the quarter ended and nine months ended September 30, 2006 compared to the same periods of 2005. These increases in non-interest expense were largely attributable to the acquisitions of PCB Holding Company as of October 1, 2005 and Stone City Bancshares, Inc. as of January 1, 2006.

For the three and nine months ended September 30, 2006, Salaries and Employee Benefits Expense increased \$938,000 or 21% and \$2,362,000 or 17% as compared to the same periods of 2005. The increase in Salaries and Employee Benefits Expense was primarily due to an increase in full-time equivalent employees attributable to the acquisitions completed effective October 1, 2005 and January 1, 2006. Also contributing to the increase in Salaries and Employee Benefits Expense to a lesser degree was the adoption of FAS 123R, "Share Based Payments", as of January 1, 2006.

Occupancy Expense and Furniture and Equipment Expense increased by \$218,000 or 21% and \$414,000 or 13% during the quarter ended and nine months ended September 30, 2006 compared with the prior year. Data Processing Fees increased \$142,000 or 46% and \$323,000 or 34% during the three and nine months ended September 30, 2006 compared with the same periods of 2005. In all of these instances the increase in costs was in large part due to the banking acquisitions undertaken over the past year.

Professional Fees increased \$206,000 or 61% and \$177,000 or 14% during the three and nine months ended September 30, 2006 compared with the same periods of the prior year. These increases were largely attributable to expenses associated with the Company's conversion of its core processing system.

Other Operating Expenses increased by \$139,000 or 13% and \$413,000 or 13% during the three and nine months ended September 30, 2006 compared with the three and nine months ended September 30, 2005. Included in these increases was intangible amortization that resulted from the amortization of core deposit intangibles that were recorded as part of the previously discussed banking acquisitions. Amortization expense for future periods is expected to increase as a result of the amortization of the customer relationship intangible that was purchased as part of the Keach and Gove Insurance, Inc., acquisition effective October 1, 2006, as discussed in Note 13 to the Consolidated Financial Statements included in this report. Also contributing to the increase for the nine months ended September 30, 2006 was an increased level of collection costs associated with the pay-off of a \$4.2 million non-performing loan during the second quarter of 2006.

#### **Income Taxes:**

The Company's effective income tax rate approximated 30.4% and 29.0% of pre-tax income during the three and nine months ended September 30, 2006 compared with 27.2% and 25.2% during the same periods of 2005. The higher effective tax rate during the three and nine month periods ended September 30, 2006 compared with the same periods

of 2005 was the result of higher levels of before tax net income combined with a lower level of tax-exempt investment income and a lower level of tax credits generated by investments in affordable housing projects. The effective tax rate in both 2006 and 2005 was lower than the blended statutory rate of 39.6% resulting primarily from the Company's tax-exempt investment income on securities and loans, income tax credits generated from investments in affordable housing projects, and income generated by subsidiaries domiciled in a state with no state or local income tax.

Since December 31, 2001, the Company's effective tax rate has been favorably impacted by Indiana financial institution tax savings resulting from the Company's formation of investment subsidiaries in the state of Nevada by four of the Company's banking subsidiaries. The state of Nevada has no state or local income tax. During the third quarter of 2005, the Company received notices of proposed assessments of unpaid Indiana financial institutions tax for the years 2001 and 2002 of approximately \$691,000 (\$456,000 net of federal tax), including interest and penalties of approximately \$100,000. The Company filed a protest with the Indiana Department of Revenue contesting the proposed assessments and intends to vigorously defend its position that the income of the Nevada subsidiaries is not subject to the Indiana financial institutions tax. Although there can be no such assurance, at this time management does not believe that it is probable that this potential assessment will result in additional tax liability. Therefore, no tax provision has been recognized for the potential assessment of additional financial institutions tax for 2001 and 2002 or for financial institutions tax with respect to any of the Nevada subsidiaries in any period subsequent to 2002, including the nine-month period ended September 30, 2006.

## FINANCIAL CONDITION

Total assets at September 30, 2006 increased \$114.3 million to \$1.061 billion compared with \$946.5 million in total assets at December 31, 2005. Securities available-for-sale and held-to-maturity increased \$20.5 million to \$210.3 million at September 30, 2006 compared with \$189.8 million at year-end 2005. Loans, net of unearned income and allowance for loan losses, increased \$87.1 million to \$729.8 million at September 30, 2006 compared to \$642.7 million at December 31, 2005. The Company has experienced growth in all segments of its loan portfolio during the nine months ended September 30, 2006. Commercial and industrial loans increased \$69.3 million or 22%, agricultural based loans increased \$3.5 million or 3%, consumer loans increased \$3.3 million or 3% and residential mortgage loans increased \$11.6 million or 11% during the nine months ended September 30, 2006.

Total Deposits at September 30, 2006 increased \$77.5 million to \$824.3 million compared with \$746.8 in total deposits at December 31, 2005. Demand, savings, and money market accounts decreased \$7.2 million while time deposits increased \$84.7 million. FHLB Advances and Other Borrowings increased \$27.1 million to \$132.5 million at September 30, 2006 compared with \$105.4 million at December 31, 2005.

A significant contributor to the overall growth of the balance sheet, including the growth in total assets, net loans, and deposits, was the acquisition of Stone City Bancshares, Inc. during the first quarter of 2006.

### Non-performing Assets:

The following is an analysis of the Company's non-performing assets at September 30, 2006 and December 31, 2005 (dollars in thousands):

|   | September 30,<br>2006 | December 31,<br>2005 |
|---|-----------------------|----------------------|
| Non-accrual Loans                               | \$ 11,638             | \$ 14,763            |
| Past Due Loans (90 days or more)                | 7                     | 944                  |
| Restructured Loans                              | ---                   | ---                  |
| Total Non-performing Loans                      | 11,645                | 15,707               |
| Other Real Estate                               | 1,082                 | 506                  |
| Total Non-performing Assets                     | \$ 12,727             | \$ 16,213            |
| Allowance for Loan Loss to Non-performing Loans | 78.24%                | 58.99%               |
| Non-performing Loans to Total Loans             | 1.58%                 | 2.41%                |

The Company's level of overall non-performing assets declined by approximately \$3.5 million and non-performing loans declined by approximately \$4.1 million during nine months ended September 30, 2006. The decline in the level of non-accrual loans resulted from the resolution of an approximately \$4.2 million credit facility, which was extended to a borrower operating a retail grocery store chain. Under an approved bankruptcy plan, the Company was paid approximately 90% of the amount owed to it during April 2006.

The level of non-performing loans remains at higher than historic levels, but is largely attributable to two specific credit facilities that were placed on non-accrual status during 2005. The first of these credits is an approximately \$1.4 million loan to a manufacturing entity which has ceased operations. During the latter part of the third quarter of 2005, the real estate and equipment of the manufacturing entity were sold at auction. The sale is expected to be completed in the first quarter of 2007. The indebtedness owed the Company on this credit is secured by a first priority lien on substantially all of the borrower's assets, including those sold at auction.



The second of these specific credits, which totals approximately \$5.2 million, was extended to a borrower operating two hotel facilities. This credit is secured by a first priority lien on the hotel facilities. The Company has taken preliminary steps to place the properties under control of an independent management company in the event that foreclosure action is completed. Currently, negotiations are continuing for the sale of the hotel facilities to a party unrelated to the borrower.

The Company will continue to assess the internal classification of these credits and the level of specific allocation of the loan loss reserve attributable to these credits based upon the best information that is available from time to time, including the status of the sale of the manufacturing facility and of the hotel facilities.

**Capital Resources:**

Federal banking regulations provide guidelines for determining the capital adequacy of bank holding companies and banks. These guidelines provide for a more narrow definition of core capital and assign a measure of risk to the various categories of assets. The Company is required to maintain minimum levels of capital in proportion to total risk-weighted assets and off-balance sheet exposures such as loan commitments and standby letters of credit.

Tier 1, or core capital, consists of shareholders' equity less goodwill, core deposit intangibles, and certain deferred tax assets defined by bank regulations. Tier 2 capital currently consists of the amount of the allowance for loan losses which does not exceed a defined maximum allowance limit of 1.25 percent of gross risk adjusted assets. Total capital is the sum of Tier 1 and Tier 2 capital.

The minimum requirements under these standards are generally at least a 4.0 percent leverage ratio, which is Tier 1 capital divided by defined "total assets"; 4.0 percent Tier 1 capital to risk-adjusted assets; and, an 8.0 percent total capital to risk-adjusted assets ratios. Under these guidelines, the Company, on a consolidated basis, and its subsidiary bank, have capital ratios that exceed the regulatory minimums.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires federal regulatory agencies to define capital tiers. These are: well-capitalized, adequately-capitalized, under-capitalized, significantly under-capitalized, and critically under-capitalized. Under these regulations, a "well-capitalized" entity must achieve a Tier 1 Risk-based capital ratio of at least 6.0 percent; a total capital ratio of at least 10.0 percent; and, a leverage ratio of at least 5.0 percent, and not be under a capital directive. The Company's subsidiary bank was categorized as well-capitalized as of September 30, 2006.

At September 30, 2006, management was not under such a capital directive, nor was it aware of any current recommendations by banking regulatory authorities which, if they were to be implemented, would have or are reasonably likely to have, a material effect on the Company's liquidity, capital resources or operations.

The table below presents the Company's consolidated capital ratios under regulatory guidelines:

| <b>Minimum for<br/>Capital<br/>Adequacy<br/>Purposes</b> | <b>To be Well<br/>Capitalized<br/>Under Prompt<br/>Corrective<br/>Action<br/>Provisions<br/>(FDICIA)</b> | <b>At<br/>September 30,<br/>2006</b> | <b>At<br/>December 31,<br/>2005</b> |
|--|--|--------------------------------------|-------------------------------------|
|--|--|--------------------------------------|-------------------------------------|

|  |       |        |        |        |
|--|-------|--------|--------|--------|
| Leverage Ratio                         | 4.00% | 5.00%  | 7.73%  | 8.01%  |
| Tier 1 Capital to Risk-adjusted Assets | 4.00% | 6.00%  | 9.40%  | 10.01% |
| Total Capital to Risk-adjusted Assets  | 8.00% | 10.00% | 10.54% | 11.27% |

As of September 30, 2006, shareholders' equity increased by \$8.7 million to \$91.0 million compared with \$82.3 million at year-end 2005. Shareholders' equity represented 8.6% of total assets at September 30, 2006 compared with 8.7% at December 31, 2005. Shareholders' equity included \$12.6 million of goodwill and other intangible assets at September 30, 2006, compares to \$6.2 million of goodwill and other intangible assets at December 31, 2005, and intangible assets increased effective October 1, 2006 by approximately \$2.2 as a result of the acquisition of Keach and Grove Insurance, Inc. discussed in Note 13 to the Consolidated Financial Statements included herein.

## **Liquidity:**

The Consolidated Statement of Cash Flows details the elements of changes in the Company's consolidated cash and cash equivalents. Total cash and cash equivalents increased approximately \$0.2 million during the nine months ended September 30, 2006 ending at \$33.1 million compared with \$32.9 million at year-end 2005. During the nine months ended September 30, 2006, cash flows from operating activities provided \$9.4 million of available cash, which included net income of \$7.8 million. Investing activities resulted in net cash outflows of \$53.8 million during the nine months ended September 30, 2006 due primarily to cash outflows of loans made to customers, net purchases of securities, as well as the acquisition of Stone City Bancshares, Inc. effective January 1, 2006. Financing activities provided net cash inflows for the period ended September 30, 2006 of \$44.5 million which included an increase in deposits partially offset by \$4.6 million in dividends paid to shareholders.

## **Parent Company Liquidity and Capital Resources:**

The Company is a corporation separate and distinct from its bank and other subsidiaries. The Company uses funds at the parent company level to pay dividends to its shareholders, to acquire or make other investments in other businesses or their securities or assets, to repurchase its stock from time to time, and for other general corporate purposes. The parent company does not have access at the parent-company level to the deposits and certain other sources of funds that are available to its bank subsidiaries to support their operations. Instead, the parent company has historically derived most of its revenues from dividends paid to the parent company by its bank subsidiary. The bank subsidiary is subject to statutory restrictions on its ability to pay dividends to the parent company.

The parent company has in recent years supplemented the dividends received from its subsidiaries with borrowings under a credit facility established with JPMorgan Chase Bank, N.A. (the "Lender"). Under an Amended and Restated Loan Agreement with the lender executed in September 2005, as amended effective September 20, 2006 (as so amended, the "Amended Agreement"), the parent company has borrowed \$25 million from the Lender under a term loan, and has \$15 million of credit availability under a revolving credit facility. The line of credit established by the revolving credit facility expires on September 20, 2007, at which time all amounts borrowed under that line will become due and payable. As of September 30, 2006, all of the line of credit was available for future borrowing. The Company is obligated to make annual principal reduction payments under the \$25 million term loan of \$1.0 million in September 2007, \$2.5 million in September 2008, and \$2.5 million in September 2009, and is obligated to pay the remaining \$19 million principal balance plus interest during September 2010 (at maturity of the term loan).

The Amended Agreement includes usual and customary covenants and conditions, including a covenant that requires that the Company maintain the capital ratios of the Company and of its subsidiary bank(s) at levels that would be considered "well-capitalized" under the prompt corrective action regulations of the federal banking agencies. In addition, the Company agreed in the Amended Agreement that it would maintain a consolidated ratio of (a) the sum of its non-performing loans plus other real estate owned (real estate that is neither used in the ordinary course of the business of the Company or its subsidiaries nor held for future use) (OREO) to (b) the sum of the Company's loans plus OREO, of not greater 3.75% until September 30, 2006, and of not greater than 3.25% at September 30, 2006, and at all times thereafter. At September 30, 2006, this ratio was 1.72%.

## **FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS**

The Company from time to time in its oral and written communications makes statements relating to its expectations regarding the future. These types of statements are considered "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. The Company may include forward-looking statements in filings with the Securities and Exchange Commission ("SEC"), such as this Form 10-Q, in other written materials, and in oral statements made by senior management to analysts, investors, representatives of the media, and others. Such forward

looking statements can include statements about the Company's net interest income or net interest margin; adequacy of allowance for loan losses, levels of provisions for loan losses, and the quality of the Company's loans and other assets; simulations of changes in interest rates; expected results from mergers with or acquisitions of other businesses; litigation results; tax estimates and recognition; dividend policy; parent company cash resources and cash requirements, and parent company capital resources; estimated cost savings, plans and objectives for future operations; and expectations about the Company's financial and business performance and other business matters as well as economic and market conditions and trends. They often can be identified by the use of words like "expect," "may," "will," "would," "could," "should," "intend," "project," "estimate," "believe" or "anticipate," or similar expressions. In Its Quarterly Report, forward-looking statements include, but are not limited to, the statement in "RESULTS OF OPERATIONS - Income Taxes" regarding management's belief that it is not probable that a certain assessment of unpaid financial institutions tax by the Indiana Department of Revenue will result in any additional tax liability, and the statement in "RESULTS OF OPERATIONS - Non-Interest Income" regarding management's expectation as to annualized insurance commission revenues of Keach and Grove Insurance, Inc..

It is intended that these forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the forward-looking statement is made. Readers are cautioned that, by their nature, forward-looking statements are based on assumptions and are subject to risks, uncertainties, and other factors. Actual results may differ materially from the expectations of the Company that are expressed or implied by any forward-looking statement.

The discussions elsewhere in this Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations," list some of the factors that could cause the Company's actual results or experience to vary materially from those expressed or implied by any forward-looking statements. Other risks, uncertainties, and factors that could cause the Company's actual results or experiences to vary materially from those expressed or implied by any forward-looking statement include the unknown future direction of interest rates and the timing and magnitude of any changes in interest rates; effects of changes in competitive conditions; acquisitions of other businesses by the Company and costs of integrations of such acquired businesses, and the potential risk that customer relationships of such acquired businesses may be lost; the introduction, withdrawal, success and timing of business initiatives and strategies; changes in customer borrowing, repayment, investment and deposit practices; changes in fiscal, monetary and tax policies; changes in financial and capital markets; changes in general economic conditions, either nationally or regionally, resulting in, among other things, credit quality deterioration; the risk of unfavorable developments in the closing of the proposed sale of the manufacturing facility and in the proposed sales of certain hotel facilities (both as discussed above under "FINANCIAL CONDITION - Non-Performing Assets"); the impact, extent and timing of technological changes; capital management activities; actions of the Federal Reserve Board and legislative and regulatory actions and reforms; changes in accounting principles and interpretations; the inherent uncertainties involved in litigation and regulatory proceedings which could result in the Company's incurring loss or damage regardless of the merits of the Company's claims or defenses; and the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends by the Company and by its subsidiaries. Investors should consider these risks, uncertainties, and other factors, in addition to those mentioned by the Company in its Annual Report on Form 10-K for its fiscal year ended December 31, 2005, and other SEC filings from time to time, when considering any forward-looking statement.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committees and Boards of Directors of the parent company and its subsidiary bank. Primary market risks which impact the Company's operations are liquidity risk and interest rate risk.

The liquidity of the parent company is dependent upon the receipt of dividends from its subsidiary bank, which is subject to certain regulatory limitations. The bank's source of funding is predominately core deposits, maturities of securities, repayments of loan principal and interest, federal funds purchased, securities sold under agreements to repurchase and borrowings from the Federal Home Loan Bank.

The Company monitors interest rate risk by the use of computer simulation modeling to estimate the potential impact on its net interest income under various interest rate scenarios, and by estimating its static interest rate sensitivity position. Another method by which the Company's interest rate risk position can be estimated is by computing estimated changes in its net portfolio value ("NPV"). This method estimates interest rate risk exposure from movements in interest rates by using interest rate sensitivity analysis to determine the change in the NPV of discounted cash flows from assets and liabilities.

NPV represents the market value of portfolio equity and is equal to the estimated market value of assets minus the estimated market value of liabilities. Computations are based on a number of assumptions, including the relative

levels of market interest rates and prepayments in mortgage loans and certain types of investments. These computations do not contemplate any actions management may undertake in response to changes in interest rates, and should not be relied upon as indicative of actual results. In addition, certain shortcomings are inherent in the method of computing NPV. Should interest rates remain or decrease below current levels, the proportion of adjustable rate loans could decrease in future periods due to refinancing activity. In the event of an interest rate change, prepayment levels would likely be different from those assumed in the table. Lastly, the ability of many borrowers to repay their adjustable rate debt may decline during a rising interest rate environment.

The table below provides an assessment of the risk to NPV in the event of a sudden and sustained 2% increase and decrease in prevailing interest rates (dollars in thousands).

**Interest Rate Sensitivity as of September 30, 2006**

| Changes<br>In rates | Net Portfolio<br>Value |          | Net Portfolio Value<br>as a % of Present Value<br>of Assets |           |
|---------------------|------------------------|----------|---|-----------|
|                     | \$ Amount              | % Change | NPV Ratio   | Change    |
| +2%                 | \$118,052              | (4.59)%  | 11.44%  | (23) b.p. |
| Base                | 123,730                | ---      | 11.67   | ---       |
| -2%                 | 119,002                | (3.82)%  | 11.01   | (66) b.p. |

This Item 3 includes forward-looking statements. See “Forward-looking Statements” included in Part I, Item 2 of this Report for a discussion of certain factors that could cause the Company’s actual exposure to market risk to vary materially from that expressed or implied above. These factors include possible changes in economic conditions; interest rate fluctuations, competitive product and pricing pressures within the Company’s markets; and equity and fixed income market fluctuations. Actual experience may also vary materially to the extent that the Company’s assumptions described above prove to be inaccurate.

**Item 4. Controls and Procedures**

As of September 30, 2006, the Company carried out an evaluation, under the supervision and with the participation of its principal executive officer and principal financial officer, of the effectiveness of the design and operation of its disclosure controls and procedures. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures were as of that date effective in timely alerting them to material information required to be included in the Company's periodic reports filed with the Securities and Exchange Commission. There are inherent limitations to the effectiveness of systems of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective systems of disclosure controls and procedures can provide only reasonable assurances of achieving their control objectives.

There was no change in the Company’s internal control over financial reporting that occurred during the Company’s third fiscal quarter of 2006 that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

**PART II. OTHER INFORMATION****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(e) The following table sets forth information regarding the Company's purchases of its common shares during each of the three months ended September 30, 2006.

| Period           | Total Number Of Shares (or Units) Purchased | Average Price Paid Per Share (or Unit) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs <sup>(1)</sup> |
|------------------|---|--|---|--|
| 7/1/06 - 7/30/06 | ---   | ---                                    | ---   | 272,789  |
| 8/1/06 - 8/31/06 | ---   | ---                                    | ---   | 272,789  |
| 9/1/06 - 9/30/06 | ---   | ---                                    | ---   | 272,789  |
|                  | ---   | ---                                    | ---   |  |

<sup>(1)</sup> On April 26, 2001, the Company announced that its Board of Directors had approved a stock repurchase program for up to 607,754 of its outstanding common shares, of which the Company had purchased 334,965 common shares through September 30, 2006 (both such numbers adjusted for subsequent stock dividends). The Board of Directors established no expiration date for this program. The Company purchased no shares under this program during the quarter ended September 30, 2006.

**Item 6. Exhibits**

The exhibits described by the Exhibit Index immediately following the Signature Page of this Report are incorporated herein by reference.



**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.

GERMAN AMERICAN BANCORP, INC.

Date November 7, 2006

By /s/ Mark A. Schroeder  
Mark A. Schroeder  
President and Chief Executive Officer

Date November 7, 2006

By /s/ Bradley M. Rust  
Bradley M. Rust  
Senior Vice President and  
Chief Financial Officer

**INDEX OF EXHIBITS**

| <b><u>Exhibit No.</u></b> | <b><u>Description</u></b>  |
|---------------------------|--|
| 3.1                       | Restatement of Articles of Incorporation of the Registrant. This exhibit is incorporated by reference from Exhibit 3.1 to the Registrant's Quarterly Report on Form 8-K filed May 22, 2006.  |
| 3.2                       | Restated Bylaws of the Registrant, as amended April 22, 2004. This exhibit is incorporated by reference from Exhibit 3.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004.  |
| 4.1                       | Rights Agreement dated April 27, 2000. This exhibit is incorporated by reference from Exhibit 4.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005.  |
| 4.2                       | No long-term debt instrument issued by the Registrant exceeds 10% of consolidated total assets or is registered. In accordance with paragraph 4 (iii) of Item 601(b) of Regulation S-K, the Registrant will furnish the Securities and Exchange Commission copies of long-term debt instruments and related agreements upon request. |
| 4.3                       | Terms of Common Shares and Preferred Shares of the Registrant (included in Restatement of Articles of Incorporation). This exhibit is incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005.   |
| 10.1                      | Amendment No. 1 to Amended and Restated Loan Agreement between the Registrant and JPMorgan Chase Bank, N.A., dated September 20, 2006.   |
| 10.2                      | Revolving Note made by the Registrant payable to JPMorgan Chase Bank, N.A., dated September 20, 2006.  |
| 10.3                      | Amended and Restated Loan Agreement dated as of September 20, 2005, by and between JPMorgan Chase Bank, N.A., and the Registrant. This exhibit is incorporated by reference from Exhibit 99 to the Registrant's Current Report on Form 8-K filed September 30, 2005.   |
| 31.1                      | Sarbanes-Oxley Act of 2002, Section 302 Certification for President and Chief Executive Officer.   |
| 31.2                      | Sarbanes-Oxley Act of 2002, Section 302 Certification for Senior Vice President (Principal Financial Officer).   |
| 32.1                      |  |

|      |  |
|------|--|
|      | Sarbanes-Oxley Act of 2002, Section 906 Certification for President and Chief Executive Officer.               |
| 32.2 | Sarbanes-Oxley Act of 2002, Section 906 Certification for Senior Vice President (Principal Financial Officer). |

\*Exhibits that describe or evidence all management contracts or compensatory plans or arrangements required to be filed as exhibits to this Report are indicated by an “X” in this column.

\*\* Certain exhibits to these documents have been omitted from the text filed with the SEC. The omitted information is considered immaterial from an investor's perspective. The Registrant will furnish supplementally a copy of any of any such omitted exhibit to the SEC upon request from the SEC.