HAWTHORN BANCSHARES, INC.
Form 10-Q
November 14, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

or

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

For the transition period from to

Commission File Number: 0-23636

HAWTHORN BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

Missouri	**43-1626350**

(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)

132 East High Street, Box 688, Jefferson City, Missouri 65102

(Address of principal executive offices) (Zip Code)

(573) 761-6100

(Registrant s telephone number, including area code)

N/A

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). **x** Yes o No

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

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

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

As of November 14, 2013, the registrant had 5,032,679 shares of common stock, par value $1.00 per share, outstanding

Index to Exhibits located on page 61

Part I - FINANCIAL INFORMATION

Item 1. Financial Statements

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets *(unaudited)*

(In thousands, except per share data)

	September 30, 2013	December 31, 2012
ASSETS		
Cash and due from banks	$ 24,683	$ 31,020
Federal funds sold and other overnight interest-bearing deposits	1,090	27,857
Cash and cash equivalents	25,773	58,877
Investment in available-for-sale securities, at fair value	213,629	200,246
Loans	823,042	846,984
Allowances for loan losses	(14,254)	(14,842)
Net loans	808,788	832,142
Premises and equipment - net	37,602	37,021
Investments in Federal Home Loan Bank stock and other equity securities, at cost	4,001	3,925
Mortgage servicing rights	3,079	2,549
Other real estate owned and repossessed assets - net	15,868	23,592
Accrued interest receivable	4,956	5,190
Cash surrender value - life insurance	2,192	2,136
Other assets	15,427	15,928
Total assets	$ 1,131,315	$ 1,181,606
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits		
Non-interest bearing demand	$ 179,959	$ 192,271
Savings, interest checking and money market	412,887	405,702
Time deposits $100,000 and over	115,370	120,777
Other time deposits	243,262	272,525
Total deposits	951,478	991,275
Federal funds purchased and securities sold under agreements to repurchase	25,007	21,058
Subordinated notes	49,486	49,486
Federal Home Loan Bank advances	24,013	20,126
Accrued interest payable	456	909
Other liabilities	9,048	6,532
Total liabilities	1,059,488	1,089,386
Stockholders equity:		
Preferred stock, $0.01 par value per share, 1,000,000 shares authorized; Issued 0 shares and 18,255 shares, respectively, $1,000 per share liquidation value, net of discount	0	17,977
Common stock, $1 par value, authorized 15,000,000 shares; Issued 5,194,537 and 5,000,972 shares, respectively	5,195	5,001
Surplus	33,380	31,816
Retained earnings	38,609	39,118
Accumulated other comprehensive (loss) income, net of tax	(1,840)	1,825
Treasury stock; 161,858 shares, at cost	(3,517)	(3,517)
Total stockholders equity	71,827	92,220

Total liabilities and stockholders equity	$	1,131,315	$	1,181,606

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Operations ***(unaudited)***

(In thousands, except per share amounts)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
INTEREST INCOME				
Interest and fees on loans	$ 10,186	$ 10,881	$ 31,009	$ 33,068
Interest on debt securities:				
Taxable	873	1,016	2,689	3,216
Nontaxable	212	225	641	688
Federal funds sold and other overnight interest-bearing deposits	6	6	35	43
Dividends on other securities	21	23	62	79
Total interest income	11,298	12,151	34,436	37,094
INTEREST EXPENSE				
Interest on deposits:				
Savings, interest checking and money market	238	265	752	919
Time deposit accounts $100,000 and over	224	297	705	1,316
Other time deposits	535	979	2,275	2,286
Interest on federal funds purchased and securities sold under agreements to repurchase	7	7	17	17
Interest on subordinated notes	323	346	963	1,045
Interest on Federal Home Loan Bank advances	106	135	315	403
Total interest expense	1,433	2,029	5,027	5,986
Net interest income	9,865	10,122	29,409	31,108
Provision for loan losses	0	4,700	2,000	7,900
Net interest income after provision for loan losses	9,865	5,422	27,409	23,208
NON-INTEREST INCOME				
Service charges on deposit accounts	1,463	1,360	4,213	4,067
Trust department income	179	234	598	670
Real estate servicing fees, net	338	(62)	760	(348)
Gain on sale of mortgage loans, net	175	779	1,515	1,773
Gain on sale of investment securities	0	26	554	26
Other	292	343	903	905
Total non-interest income	2,447	2,680	8,543	7,093
NON-INTEREST EXPENSE				
Salaries and employee benefits	4,863	4,761	14,596	14,465
Occupancy expense, net	695	666	1,973	1,953
Furniture and equipment expense	474	431	1,438	1,403
FDIC insurance assessment	253	249	753	752
Legal, examination, and professional fees	207	284	727	880
Advertising and promotion	310	288	907	750
Postage, printing, and supplies	308	274	854	817
Processing expense	749	888	2,758	2,667
Other real estate expense, net	1,265	1,725	4,437	3,174
Other	848	812	2,745	3,094
Total non-interest expense	9,972	10,378	31,188	29,955
Income (loss) before income taxes	2,340	(2,276)	4,764	346
Income tax expense (benefit)	771	(704)	1,519	(273)
Net income (loss)	1,569	(1,572)	3,245	619
Preferred stock dividends	0	228	337	894
Accretion of discount on preferred stock	0	72	278	587
Total preferred stock dividends and accretion of discount on preferred stock	0	300	615	1,481

Net income (loss) available to common shareholders	$ 1,569	$ (1,872)	$ 2,630	$ (862)
Basic earnings (loss) per share	$ 0.31	$ (0.37)	$ 0.52	$ (0.17)
Diluted earnings (loss) per share	$ 0.31	$ (0.37)	$ 0.52	$ (0.17)

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (loss) *(unaudited)*

(In thousands)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Net income (loss)	$ 1,569	$ (1,572)	$ 3,245	$ 619
Other comprehensive (loss) income, net of tax				
Securities available for sale:				
Unrealized (loss) gain on investment securities available-for-sale, net of tax	(109)	315	(3,372)	369
Adjustment for gain on sales of investment securities, net of tax	0	(16)	(343)	(16)
Defined benefit pension plans:				
Amortization of prior service cost included in net periodic pension cost, net of tax	16	26	50	78
Total other comprehensive (loss) income	(93)	325	(3,665)	431
Total comprehensive income (loss)	$ 1,476	$ (1,247)	$ (420)	$ 1,050

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity *(unaudited)*

(In thousands)	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stock - holders Equity
Balance, December 31, 2011	$ 29,318	$ 4,815	$ 30,266	$ 40,354	$ 1,340	$ (3,517)	$ 102,576
Cumulative effect of change in accounting principle	0	0	0	460	0	0	460
Balance, January 1, 2012	$ 29,318	$ 4,815	$ 30,266	$ 40,814	$ 1,340	$ (3,517)	$ 103,036
Net income	0	0	0	619	0	0	619
Other comprehensive income	0	0	0	0	431	0	431
Stock based compensation expense	0	0	27	0	0	0	27
Accretion of preferred stock discount	587	0	0	(587)	0	0	0
Redemption of 12,000 shares of preferred stock	(12,000)	0	0	0	0	0	(12,000)
Stock dividend	0	186	1,521	(1,707)	0	0	0
Cash dividends declared, preferred stock	0	0	0	(975)	0	0	(975)
Cash dividends declared, common stock	0	0	0	(707)	0	0	(707)
Balance, September 30, 2012	**$ 17,905**	**$ 5,001**	**$ 31,814**	**$ 37,457**	**$ 1,771**	**$ (3,517)**	**$ 90,431**
Balance, December 31, 2012	$ 17,977	$ 5,001	$ 31,816	$ 39,118	$ 1,825	$ (3,517)	$ 92,220
Net income	0	0	0	3,245	0	0	3,245
Other comprehensive loss	0	0	0	0	(3,665)	0	(3,665)
Stock based compensation expense	0	0	14	0	0	0	14
Accretion of preferred stock discount	278	0	0	(278)	0	0	0
Redemption of 18,255 shares of preferred stock	(18,255)	0	0	0	0	0	(18,255)
Redemption of common stock warrant	0	0	(540)	0	0	0	(540)
Stock dividend	0	194	2,090	(2,284)	0	0	0
Cash dividends declared, preferred stock	0	0	0	(456)	0	0	(456)
Cash dividends declared, common stock	0	0	0	(736)	0	0	(736)
Balance, September 30, 2013	**$** 0	**$** 5,195	**$** 33,380	**$** 38,609	**$** (1,840)	**$** (3,517)	$ 71,827

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows ***(unaudited)***

(In thousands)	Nine Months Ended September 30, 2013	2012
Cash flows from operating activities:		
Net income	$ 3,245	$ 619
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	2,000	7,900
Depreciation expense	1,204	1,447
Net amortization of investment securities, premiums, and discounts	981	851
Amortization of intangible assets	135	307
Stock based compensation expense	14	27
Change in fair value of mortgage servicing rights	(86)	985
Gain on sale of investment securities	(554)	(26)
Loss (gain) on sales and dispositions of premises and equipment	2	(82)
Loss (gain) on sales and dispositions of other real estate owned and repossessed assets	390	(220)
Provision for other real estate owned	3,031	1,821
Decrease (increase) in accrued interest receivable	234	(126)
Increase in cash surrender value -life insurance	(56)	(55)
Decrease in other assets	1,729	679
Decrease (increase) in income tax receivable	963	(1,714)
Increase in income tax payable	424	0
Decrease in accrued interest payable	(453)	(370)
Increase in other liabilities	2,083	823
Origination of mortgage loans for sale	(61,297)	(67,089)
Proceeds from the sale of mortgage loans	63,452	68,506
Gain on sale of mortgage loans, net	(1,515)	(1,773)
Other, net	(362)	44
Net cash provided by operating activities	15,564	12,554
Cash flows from investing activities:		
Net decrease (increase) in loans	17,436	(20,929)
Purchase of available-for-sale debt securities	(76,479)	(69,305)
Proceeds from maturities of available-for-sale debt securities	28,221	32,192
Proceeds from calls of available-for-sale debt securities	6,255	33,095
Proceeds from sales of available-for-sale debt securities	22,115	790
Proceeds from sales of FHLB stock	535	100
Purchases of FHLB stock	(612)	0
Purchases of premises and equipment	(1,787)	(1,155)
Proceeds from sales of premises and equipment	0	269
Proceeds from sales of other real estate owned and repossessed assets	7,586	5,553
Net cash provided (used) by investing activities	3,270	(19,390)
Cash flows from financing activities:		
Net (decrease) increase in demand deposits	(12,312)	5,944
Net increase in interest-bearing transaction accounts	7,185	5,034
Net decrease in time deposits	(34,670)	(12,792)
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	3,949	(407)
Repayment of FHLB advances	(15,113)	(194)
FHLB advances	19,000	0
Redemption of 18,255 and 12,000 shares, respectively, of preferred stock	(18,255)	(12,000)
Warrant redemption	(540)	0
Cash dividends paid - preferred stock	(456)	(975)
Cash dividends paid - common stock	(726)	(698)

Net cash used by financing activities		(51,938)		(16,088)
Net decrease in cash and cash equivalents		(33,104)		(22,924)
Cash and cash equivalents, beginning of period		58,877		43,210
Cash and cash equivalents, end of period	$	25,773	$	20,286

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (continued) ***(unaudited)***

(In thousands)	Nine Months Ended September 30, 2013	2012
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 5,479	$ 6,724
Income taxes	$ 131	$ 1,575
Supplemental schedule of noncash investing and financing activities:		
Other real estate and repossessions acquired in settlement of loans	$ 3,278	$ 16,328

See accompanying notes to the unaudited consolidated financial statements.

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

(Unaudited)

(1) Summary of Significant Accounting Policies

Hawthorn Bancshares, Inc. (the Company) through its subsidiary, Hawthorn Bank (the Bank), provides a broad range of banking services to individual and corporate customers located within the communities in and surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson, and Lee s Summit, Missouri. The Company is subject to competition from other financial and nonfinancial institutions providing financial products. Additionally, the Company and its subsidiaries are subject to the regulations of certain regulatory agencies and undergo periodic examinations by those regulatory agencies.

The accompanying unaudited consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q, and Rule 10-01 of Regulation S-X. Accordingly, the unaudited consolidated financial statements do not include all of the information and disclosures required by U.S. GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

The accompanying unaudited consolidated financial statements include all adjustments that, in the opinion of management, are necessary in order to make those statements not misleading. Management is required to make estimates and assumptions, including the determination of the allowance for loan losses, real estate acquired in connection with foreclosure or in satisfaction of loans, fair values of investment securities available-for-sale, and the valuation of mortgage servicing rights that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company s management has evaluated and did not identify any subsequent events or transactions requiring recognition or disclosure in the consolidated financial statements.

Stock Dividend On July 1, 2013, the Company paid a special stock dividend of four percent to common shareholders of record at the close of business on June 15, 2013. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

The following represents significant new accounting principles adopted in 2013:

Balance Sheet In December 2011, the FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities.* The ASU is a joint requirement by the FASB and International Accounting Standards Board to enhance current disclosures and increase comparability of U.S. GAAP and International Financial Reporting Standards (IFRS) financial statements. Under the ASU, an entity will be required to disclose both gross and net information about instruments and transactions eligible for offset in the balance sheet, as well as instruments and transactions subject to an agreement similar to a master netting agreement. ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities,* was issued in January 2013, and amended ASU 2011-11 to specifically include only derivatives accounted for under Topic 815, repurchase and reverse purchase agreements, and securities and borrowing and lending transactions that are either offset or subject to an enforceable master netting arrangement. Both ASUs are effective for annual and interim periods beginning January 1, 2013. The adoption of these ASUs had no effect on the Company s financial statements.

Other Comprehensive Income In February 2013, the FASB issued ASU No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* (AOCI). The amendments of ASU No. 2013-02 require an entity to present, either in the income statement or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety, an entity is required to cross-reference to other disclosures that provide additional detail about those amounts. This ASU is effective for annual and interim periods beginning January 1, 2013. As a result of the adoption of the ASU, the disclosure of AOCI included in Note 7 contains information regarding reclassifications out of AOCI and into net income.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

(2) Loans and Allowance for Loan Losses

Loans

A summary of loans, by major class within the Company s loan portfolio, at September 30, 2013 and December 31, 2012 is as follows:

(in thousands)		September 30, 2013		December 31, 2012
Commercial, financial, and agricultural	$	132,923	$	130,040
Real estate construction - residential		23,664		22,177
Real estate construction - commercial		48,489		43,486
Real estate mortgage - residential		220,174		221,223
Real estate mortgage - commercial		375,876		405,092
Installment and other consumer		21,916		24,966
Total loans	$	823,042	$	846,984

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the communities surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee s Summit, Missouri. As such, the Bank is susceptible to changes in the economic environment in these communities. The Bank does not have a concentration of credit in any one economic sector. Installment and other consumer loans consist primarily of the financing of vehicles. At September 30, 2013, loans with a carrying value of $383.4 million were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit.

Allowance for loan losses

The following is a summary of the allowance for loan losses for the three and nine months ended September 30, 2013, and 2012:

Three Months Ended September 30, 2013					
Commercial,	Real Estate	Real Estate	Real Estate	Real Estate	Installment

(in thousands)	Financial, & Agricultural	Construction - Residential	Construction - Commercial	Mortgage - Residential	Mortgage - Commercial	Loans to Individuals	Un-allocated	Total
Balance at beginning of period	**$ 2,119**	**$ 932**	**$ 2,202**	**$ 2,456**	**$ 7,415**	**$ 233**	**$ 1**	**$ 15,358**
Additions:								
Provision for loan losses	444	32	(216)	4	(294)	25	5	0
Deductions:								
Loans charged off	654	0	135	368	178	91	0	1,426
Less recoveries on loans	(201)	0	0	(39)	(34)	(48)	0	(322)
Net loans charged off	453	0	135	329	144	43	0	1,104
Balance at end of period	**$ 2,110**	**$ 964**	**$ 1,851**	**$ 2,131**	**$ 6,977**	**$ 215**	**$ 6**	**$ 14,254**

	Nine Months Ended September 30, 2013							
(in thousands)	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
Balance at beginning of period	**$ 1,937**	**$ 732**	**$ 1,711**	**$ 3,387**	**$ 6,834**	**$ 239**	**$ 2**	**$ 14,842**
Additions:								
Provision for loan losses	725	351	273	(586)	1,142	91	4	2,000
Deductions:								
Loans charged off	817	119	135	754	1,205	271	0	3,301
Less recoveries on loans	(265)	0	(2)	(84)	(206)	(156)	0	(713)
Net loans charged off	552	119	133	670	999	115	0	2,588
Balance at end of period	**$ 2,110**	**$ 964**	**$ 1,851**	**$ 2,131**	**$ 6,977**	**$ 215**	**$ 6**	**$ 14,254**

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

	Three Months Ended September 30, 2012							
(in thousands)	**Commercial, Financial, & Agricultural**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment Loans to Individuals**	**Un-allocated**	**Total**
Balance at beginning of period	**$ 3,045**	**$ 709**	**$ 1,644**	**$ 3,560**	**$ 6,107**	**$ 232**	**$ 17**	**$ 15,314**
Additions:								
Provision for loan losses	1,239	(68)	90	118	3,241	91	(11)	4,700
Deductions:								
Loans charged off	742	0	0	41	2,366	154	0	3,303
Less recoveries on loans	(18)	0	0	(19)	(96)	(76)	0	(209)
Net loans charged off	724	0	0	22	2,270	78	0	3,094
Balance at end of period	**$ 3,560**	**$ 641**	**$ 1,734**	**$ 3,656**	**$ 7,078**	**$ 245**	**$ 6**	**$ 16,920**

	Nine Months Ended September 30, 2012							
(in thousands)	**Commercial, Financial, & Agricultural**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment Loans to Individuals**	**Un-allocated**	**Total**
Balance at beginning of period	**$ 1,804**	**$ 1,188**	**$ 1,562**	**$ 3,251**	**$ 5,734**	**$ 267**	**$ 3**	**$ 13,809**
Additions:								
Provision for loan losses	2,469	(614)	149	913	4,793	187	3	7,900
Deductions:								
Loans charged off	846	0	0	618	3,666	425	0	5,555
Less recoveries on loans	(133)	(67)	(23)	(110)	(217)	(216)	0	(766)
Net loans charged off	713	(67)	(23)	508	3,449	209	0	4,789
Balance at end of period	**$ 3,560**	**$ 641**	**$ 1,734**	**$ 3,656**	**$ 7,078**	**$ 245**	**$ 6**	**$ 16,920**

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

(Unaudited)

Loans, or portions of loans, are charged off to the extent deemed uncollectible or a loss is confirmed. Loan charge-offs reduce the allowance for loan losses, and recoveries of loans previously charged off are added back to the allowance. If management determines that it is probable that all amounts due on a loan will not be collected under the original terms of the loan agreement, the loan is considered to be impaired. These loans are evaluated individually for impairment, and in conjunction with current economic conditions and loss experience, specific reserves are estimated as further discussed below. Loans not individually evaluated are aggregated by risk characteristics and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type, delinquencies, current economic conditions, loan risk ratings and industry concentration. Although the allowance for loan losses are comprised of specific and general allocations, the entire allowance is available to absorb credit losses.

The following table provides the balance in the allowance for loan losses at September 30, 2013 and December 31, 2012, and the related loan balance by impairment methodology.

(in thousands)	Commercial, Financial, and Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un - allocated	Total
September 30, 2013								
Allowance for loan losses:								
Individually evaluated for impairment	$ 576	$ 248	$ 250	$ 719	$ 2,782	$ 6	$ 0	$ 4,581
Collectively evaluated for impairment	1,534	716	1,601	1,412	4,195	209	6	9,673
Total	**$ 2,110**	**$ 964**	**$ 1,851**	**$ 2,131**	**$ 6,977**	**$ 215**	**$ 6**	**$ 14,254**
Loans outstanding:								
Individually evaluated for impairment	$ 4,392	$ 2,254	$ 7,101	$ 5,217	$ 16,948	$ 44	$ 0	$ 35,956
Collectively evaluated for impairment	128,531	21,410	41,388	214,957	358,928	21,872	0	787,086
Total	**$ 132,923**	**$ 23,664**	**$ 48,489**	**$ 220,174**	**$ 375,876**	**$ 21,916**	**$ 0**	**$ 823,042**
December 31, 2012								
Allowance for loan losses:								
Individually evaluated for impairment	$ 213	$ 125	$ 542	$ 1,069	$ 2,071	$ 0	$ 0	$ 4,020
Collectively evaluated for impairment	1,724	607	1,169	2,318	4,763	239	2	10,822

Total	**$**	**1,937**	**$**	**732**	**$**	**1,711**	**$**	**3,387**	**$**	**6,834**	**$**	**239**	**$**	**2**	**$**	**14,842**
Loans outstanding:																
Individually evaluated for impairment	$	4,157	$	2,496	$	7,762	$	5,771	$	18,959	$	44	$	0	$	39,189
Collectively evaluated for impairment		125,883		19,681		35,724		215,452		386,133		24,922		0		807,795
Total	**$**	**130,040**	**$**	**22,177**	**$**	**43,486**	**$**	**221,223**	**$**	**405,092**	**$**	**24,966**	**$**	**0**	**$**	**846,984**

Impaired loans

Loans evaluated under ASC 310-10-35 include loans which are individually evaluated for impairment. All other loans are collectively evaluated for impairment under ASC 450-20. Impaired loans totaled $36.2 million and $39.4 million at September 30, 2013 and December 31, 2012, respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings. Total impaired loans of $36.2 million at September 30, 2013, includes $36.0 million of impaired loans individually evaluated for impairment and $220,000 of non-accrual consumer loans that were collectively evaluated for impairment. Total impaired loans of $39.4 million at December 31, 2012, includes $39.2 million of impaired loans individually evaluated for impairment and $174,000 of non-accrual consumer loans that were collectively evaluated for impairment.

The specific reserve component applies to loans evaluated individually for impairment. The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At September 30, 2013 and December 31, 2012, $32.4 million and $36.1 million, respectively, of impaired loans were evaluated based on the fair value of the loan s collateral. Once the impairment

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

amount is calculated, a specific reserve allocation is recorded. At September 30, 2013, $4.6 million of the Company s allowance for loan losses was allocated to impaired loans totaling $36.2 million compared to $4.0 million of the Company s allowance for loan losses allocated to impaired loans totaling approximately $39.4 million at December 31, 2012. Management determined that $12.2 million, or 34%, of total impaired loans required no reserve allocation at September 30, 2013 compared to $14.7 million, or 37%, at December 31, 2012 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

The incurred loss component of the general reserve, or loans collectively evaluated for impairment, is determined by applying percentages to pools of loans by asset type. Loans not individually evaluated are aggregated based on similar risk characteristics. Historical loss rates for each risk group, which are updated quarterly, are quantified using all recorded loan charge-offs. Management determined that the previous twelve quarters were reflective of the loss characteristics of the Company s loan portfolio during the recent economic environment. These historical loss rates for each risk group are used as the starting point to determine allowance provisions. The Company s methodology includes factors that allow management to adjust its estimates of losses based on the most recent information available. The rates are then adjusted to reflect actual changes and anticipated changes such as changes in specific allowances on loans and real estate acquired through foreclosure, any gains and losses on final disposition of real estate acquired through foreclosure, changes in national and local economic conditions and developments, including general economic and business conditions affecting the Company s key lending areas, credit quality trends, specific industry conditions within portfolio segments, bank regulatory examination results, and findings of the internal loan review department. These risk factors are generally reviewed and updated quarterly, as appropriate.

The categories of impaired loans at September 30, 2013 and December 31, 2012 are as follows:

(in thousands)		**September 30, 2013**		**December 31, 2012**
Non-accrual loans	$	28,610	$	31,081
Troubled debt restructurings continuing to accrue interest		7,566		8,282
Total impaired loans	$	36,176	$	39,363

The following tables provide additional information about impaired loans at September 30, 2013 and December 31, 2012, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided.

(in thousands)	**Recorded Investment**	**Unpaid Principal Balance**	**Specific Reserves**
September 30, 2013			
With no related allowance recorded:			

Commercial, financial and agricultural	$	2,501	$	2,581	$	0
Real estate - construction residential		104		139		0
Real estate - construction commercial		2,861		3,459		0
Real estate - residential		2,419		3,214		0
Real estate - commercial		4,084		4,344		0
Consumer		220		238		0
Total	$	12,189	$	13,975	$	0
With an allowance recorded:						
Commercial, financial and agricultural	$	1,891	$	1,984	$	576
Real estate - construction residential		2,150		2,272		248
Real estate - construction commercial		4,240		4,240		250
Real estate - residential		2,798		2,931		719
Real estate - commercial		12,864		13,772		2,782
Consumer		44		44		6
Total	$	23,987	$	25,243	$	4,581
Total impaired loans	$	36,176	$	39,218	$	4,581

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

(Unaudited)

(in thousands)		Recorded Investment		Unpaid Principal Balance		Specific Reserves
December 31, 2012						
With no related allowance recorded:						
Commercial, financial and agricultural	$	3,272	$	4,009	$	0
Real estate - construction residential		2,307		2,339		0
Real estate - construction commercial		1,879		2,102		0
Real estate - residential		1,939		2,393		0
Real estate - commercial		5,162		5,565		0
Consumer		174		186		0
Total	$	14,733	$	16,594	$	0
With an allowance recorded:						
Commercial, financial and agricultural	$	885	$	898	$	213
Real estate - construction residential		189		189		125
Real estate - construction commercial		5,883		6,011		542
Real estate - residential		3,832		3,999		1,069
Real estate - commercial		13,797		14,167		2,071
Consumer		44		44		0
Total	$	24,630	$	25,308	$	4,020
Total impaired loans	$	39,363	$	41,902	$	4,020

The following table presents by class, information related to the average recorded investment and interest income recognized on impaired loans for the three and nine months ended September 30, 2013 and 2012.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
(in thousands)	Average Recorded Investment	Interest Recognized For the Period Ended	Average Recorded Investment	Interest Recognized For the Period Ended	Average Recorded Investment	Interest Recognized For the Period Ended	Average Recorded Investment	Interest Recognized For the Period Ended
With no related allowance recorded:								
Commercial, financial and agricultural	$ 2,598	$ 22	$ 3,074	$ 23	$ 2,643	$ 71	$ 3,315	$ 66
Real estate - construction residential	139	0	1,589	0	242	0	737	7
Real estate - construction commercial	3,459	0	1,879	0	3,803	0	1,653	0
Real estate - residential	3,168	10	2,299	5	3,179	10	3,333	47
Real estate - commercial	4,346	29	3,598	28	4,348	86	10,582	87

Consumer		202		0		181		0		212		1		162		1
Total	$	13,912	$	61	$	12,620	$	56	$	14,427	$	168	$	19,782	$	208
With an allowance recorded:																
Commercial, financial and agricultural	$	1,996	$	7	$	2,890	$	7	$	2,031	$	34	$	2,615	$	21
Real estate - construction residential		2,272		0		189		0		2,273		0		189		0
Real estate - construction commercial		4,240		0		6,192		0		4,240		0		6,180		0
Real estate - residential		2,920		2		3,037		4		2,947		38		2,566		11
Real estate - commercial		13,210		35		15,072		2		13,524		106		14,209		1
Consumer		44		0		0		0		44		0		0		0
Total	$	24,682	$	44	$	27,380	$	13	$	25,059	$	178	$	25,759	$	33
Total impaired loans	$	38,594	$	105	$	40,000	$	69	$	39,486	$	346	$	45,541	$	241

The recorded investment varies from the unpaid principal balance primarily due to partial charge-offs taken resulting from current appraisals received. The amount recognized as interest income on impaired loans continuing to accrue interest, primarily related to troubled debt restructurings, was $105,000 and $346,000, and $69,000 and $241,000, for the three and nine months ended September 30, 2013 and 2012, respectively. The average recorded investment on impaired loans is calculated on a monthly basis during the periods reported. Contractual interest lost on loans in non-accrual status was $929,000 at September 30, 2013 compared to $966,000 at September 30, 2012. During the three and nine months ended September 30, 2013, $1,000 and $93,000, respectively, in interest was recognized on loans in non-accrual status on a cash basis. During the three and nine months ended September 30, 2012, there was no significant interest recognized on loans in non-accrual status.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

Delinquent and Non-Accrual Loans

The delinquency status of loans is determined based on the contractual terms of the notes. Borrowers are generally classified as delinquent once payments become 30 days or more past due.

The following table provides aging information for the Company s past due and non-accrual loans at September 30, 2013 and December 31, 2012.

(in thousands)	Current or Less Than 30 Days Past Due	30 - 89 Days Past Due	90 Days Past Due And Still Accruing	Non-Accrual	Total
September 30, 2013					
Commercial, Financial, and Agricultural	$ 130,695	$ 185	$ 15	$ 2,028	$ 132,923
Real Estate Construction - Residential	21,249	160	0	2,255	23,664
Real Estate Construction - Commercial	41,388	0	0	7,101	48,489
Real Estate Mortgage - Residential	213,627	1,798	377	4,372	220,174
Real Estate Mortgage - Commercial	362,293	992	0	12,591	375,876
Installment and Other Consumer	21,378	261	14	263	21,916
Total	$ 790,630	$ 3,396	$ 406	$ 28,610	$ 823,042
December 31, 2012					
Commercial, Financial, and Agricultural	$ 126,884	$ 1,821	$ 0	$ 1,335	$ 130,040
Real Estate Construction - Residential	19,390	290	0	2,497	22,177
Real Estate Construction - Commercial	35,117	607	0	7,762	43,486
Real Estate Mortgage - Residential	213,694	2,199	0	5,330	221,223
Real Estate Mortgage - Commercial	390,032	1,122	0	13,938	405,092
Installment and Other Consumer	24,221	520	6	219	24,966
Total	$ 809,338	$ 6,559	$ 6	$ 31,081	$ 846,984

Credit Quality

The Company categorizes loans into risk categories based upon an internal rating system reflecting management s risk assessment. Loans are placed on *watch* status when (1) one or more weaknesses that could jeopardize timely liquidation exits; or (2) the margin or liquidity of an asset is sufficiently tenuous that adverse trends could result in a collection problem. Loans classified as *substandard* are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Loans so classified may have a well defined weakness or weaknesses that jeopardize the repayment of the debt. Such loans are characterized by the distinct possibility that the Company may sustain some loss if the deficiencies are not corrected. It is the Company s policy to discontinue the accrual of interest income on loans when management believes that the collection of interest or principal is doubtful. Loans are placed on *non-accrual* status when (1) deterioration in the financial condition of the borrower exists for which payment of full principal and interest is not expected, or (2) payment of principal or interest has been in default for a period of 90 days or more and the asset is not both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectability of such principal; otherwise, such receipts are recorded as interest income on a cash basis.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

The following table presents the risk categories by class at September 30, 2013 and December 31, 2012.

(in thousands)	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment and other Consumer	Total
At September 30, 2013							
Watch	$ 14,825	$ 933	$ 3,763	$ 23,272	$ 24,985	$ 399	$ 68,177
Substandard	8,506	2,564	1,082	7,794	13,885	416	34,247
Non-accrual	2,028	2,255	7,101	4,372	12,591	263	28,610
Total	$ 25,359	$ 5,752	$ 11,946	$ 35,438	$ 51,461	$ 1,078	$ 131,034
At December 31, 2012							
Watch	$ 14,814	$ 4,580	$ 6,459	$ 26,063	$ 29,753	$ 672	$ 82,341
Substandard	6,485	396	2,035	5,472	11,027	423	25,838
Non-accrual	1,335	2,497	7,762	5,330	13,938	219	31,081
Total	$ 22,634	$ 7,473	$ 16,256	$ 36,865	$ 54,718	$ 1,314	$ 139,260

Troubled Debt Restructurings

At September 30, 2013, loans classified as troubled debt restructurings (TDRs) totaled $19.3 million, of which $11.7 million was on non-accrual status and $7.6 million was on accrual status. At December 31, 2012, loans classified as TDRs totaled $22.4 million, of which $14.1 million was on non-accrual status and $8.3 million was on accrual status. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan s effective interest rate or the fair value of the underlying collateral less applicable selling costs. Accordingly, specific reserves of $1.3 million and $1.5 million related to TDRs were allocated to the allowance for loan losses at September 30, 2013 and December 31, 2012, respectively.

The following table summarizes loans that were modified as TDRs during the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended September 30,	
	2013	2012
	Recorded Investment (1)	Recorded Investment (1)
(in thousands)		

	Number of Contracts	Pre-Modification	Post-Modification	Number of Contracts	Pre-Modification	Post-Modification
Troubled Debt Restructurings						
Commercial, financial and agricultural	0	$ 0	$ 0	2	$ 100	$ 100
Real estate construction - commercial	0	0	0	0	0	0
Real estate mortgage - residential	0	0	0	2	644	644
Total	0	$ 0	$ 0	4	$ 744	$ 744

	Nine Months Ended September 30,					
	2013			2012		
		Recorded Investment (1)			Recorded Investment (1)	
(in thousands)	Number of Contracts	Pre-Modification	Post-Modification	Number of Contracts	Pre-Modification	Post-Modification
Troubled Debt Restructurings						
Commercial, financial and agricultural	0	$ 0	$ 0	3	$ 297	$ 280
Real estate construction - commercial	0	0	0	1	43	42
Real estate mortgage - residential	1	618	481	2	644	644
Total	1	$ 618	$ 481	6	$ 984	$ 966

(1) The amounts reported post-modification are inclusive of all partial pay-downs and charge-offs, and no portion of the debt was forgiven. Loans modified as a TDR that were fully paid down, charged-off or foreclosed upon during the period ended are not reported.

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

(Unaudited)

The Company s portfolio of loans classified as TDRs include concessions such as interest rates below the current market rate, deferring principal payments, and extending maturity dates. Once a loan becomes a TDR, it will continue to be reported as a TDR until it is ultimately repaid in full, charged-off, or the collateral for the loan is foreclosed and sold. The Company considers a loan in TDR status in default when the borrower s payment according to the modified terms is at least 90 days past due or has defaulted due to expiration of the loan s maturity date. During the nine months ended September 30, 2013, one loan meeting the TDR criteria was modified compared to six loans during the nine months ended September 30, 2012. During the three months ended September 30, 2013 there were no new loans modified as TDRs and four loans modified as TDRs during the three months ended September 30, 2012. There were no loans modified as a TDR that defaulted during the three and nine months ended September 30, 2013, and within twelve months of their modification date. No loans modified as a TDR during the three and nine months ended September 30, 2012 defaulted.

(3) Real Estate and Other Assets Acquired in Settlement of Loans

(in thousands)		September 30, 2013		December 31, 2012
Commercial	$	0	$	329
Real estate construction - residential		126		112
Real estate construction - commercial		10,028		13,392
Real estate mortgage - residential		908		1,227
Real estate mortgage - commercial		9,354		14,201
Repossessed assets		204		468
Total	$	20,620	$	29,729
Less valuation allowance for other real estate owned		(4,752)		(6,137)
Total other real estate owned and foreclosed assets	$	15,868	$	23,592

Changes in the net carrying amount of other real estate owned and repossessed assets for the three and nine months ended September 30, 2013 and 2012 were as follows:

	Three Months Ended September 30,				Nine Months Ended September 30,			
		2013		2012		2013		2012
Balance at beginning of period	$	21,977	$	29,057	$	29,729	$	22,997
Additions		308		7,018		3,278		16,329
Proceeds from sales		(1,348)		(2,469)		(7,581)		(5,553)
Charge-offs against the valuation allowance for other real estate owned, net		(93)		(1,075)		(4,416)		(1,318)
Repossessed assets impairment write-downs		(39)		0		(239)		0

Net (loss) gain on sales	(185)	144	(151)	220
Total other real estate owned and repossessed assets	$ 20,620	$ 32,675	$ 20,620	$ 32,675
Less valuation allowance for other real estate owned	(4,752)	(7,480)	(4,752)	(7,480)
Balance at end of period	$ 15,868	$ 25,195	$ 15,868	$ 25,195

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

(Unaudited)

Activity in the valuation allowance for other real estate owned in settlement of loans for the three and nine months ended September 30, 2013 and 2012, respectively, is summarized as follows:

(in thousands)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Balance, beginning of year	$ 3,999	$ 7,474	$ 6,137	$ 6,977
Provision for other real estate owned	846	1,081	3,031	1,821
Charge-offs	(93)	(1,075)	(4,416)	(1,318)
Balance, end of year	$ 4,752	$ 7,480	$ 4,752	$ 7,480

The increase in the expense provision for other real estate owned during 2013 primarily related to commercial property located in the Branson area that sold at auction during the second quarter of 2013. These amounts are reflected in other real estate expense in the consolidated statements of operations.

(4) Investment Securities

The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2013 and December 31, 2012 are as follows:

(in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
September 30, 2013				
U.S. Treasury	$ 1,000	$ 6	$ 0	$ 1,006
Government sponsored enterprises	64,089	423	674	63,838
Asset-backed securities	114,966	1,402	2,289	114,079
Obligations of states and political subdivisions	34,299	627	220	34,706
Total available for sale securities	$ 214,354	$ 2,458	$ 3,183	$ 213,629
December 31, 2012				
U.S. Treasury	$ 2,000	$ 30	$ 0	$ 2,030
Government sponsored enterprises	54,327	853	0	55,180
Asset-backed securities	104,607	3,276	11	107,872
Obligations of states and political subdivisions	33,959	1,222	17	35,164

Total available for sale securities	$	194,893	$	5,381	$	28	$	200,246

All of the Company s investment securities are classified as available for sale. Agency bonds and notes, agency mortgage-backed securities and agency collateralized mortgage obligations (CMO) include securities issued by the Government National Mortgage Association (GNMA), a U.S. government agency, and the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal Home Loan Bank (FHLB), which are U.S. government-sponsored enterprises.

Investment securities that are classified as restricted equity securities primarily consist of Federal Home Loan Bank stock and the Company s interest in statutory trusts. These securities are reported at cost in other assets in the amount of $4.0 million and $3.9 million as of September 30, 2013 and December 31, 2012, respectively.

Debt securities with carrying values aggregating approximately $154.5 million and $146.4 million at September 30, 2013 and December 31, 2012, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

(Unaudited)

The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2013 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without prepayment penalties.

(in thousands)	**Amortized cost**	**Fair value**
Due in one year or less	$ 6,432	$ 6,482
Due after one year through five years	59,976	60,495
Due after five years through ten years	31,843	31,488
Due after ten years	1,137	1,085
Total	99,388	99,550
Asset-backed securities	114,966	114,079
Total available for sale securities	$ 214,354	$ 213,629

Gross unrealized losses on debt securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2013 and December 31, 2012 were as follows:

[redacted]						
At September 30, 2013						
Government sponsored enterprises	$ 27,876	$ (674)	$ 0	$ 0	$ 27,876	$ (674)
Asset-backed securities	68,464	(2,281)	790	(8)	69,254	(2,289)
Obligations of states and political subdivisions	9,636	(220)	0	0	9,636	(220)
Total	**$ 105,976**	**$ (3,175)**	**$ 790**	**$ (8)**	**$ 106,766**	**$ (3,183)**

[redacted]						
At December 31, 2012						
Government sponsored enterprises	$ 1,044	$ 0	$ 0	$ 0	$ 1,044	$ 0
Asset-backed securities	4,729	(11)	0	0	4,729	(11)
Obligations of states and political subdivisions	2,114	(17)	150	0	2,264	(17)
Total	**$ 7,887**	**$ (28)**	**$ 150**	**$ 0**	**$ 8,037**	**$ (28)**

The total available for sale portfolio consisted of approximately 350 securities at September 30, 2013. The portfolio included 100 securities having an aggregate fair value of $106.8 million that were in a loss position at September 30, 2013. Securities identified as temporarily impaired which have been in a loss position for 12 months or longer totaled $790,000 at fair value. The $3.2 million aggregate unrealized loss included in accumulated other comprehensive income (loss) at September 30, 2013 was caused by interest rate fluctuations. The total available for sale portfolio consisted of approximately 380 securities at December 31, 2012. The portfolio included 14 securities having an aggregate fair value of $8.0 million that were in a loss position at December 31, 2012. Securities identified as temporarily impaired which have been in a loss position for 12 months or longer totaled $150,000 at fair value. The $28,000 aggregate unrealized loss included in other comprehensive income at December 31, 2012 was caused by interest rate fluctuations. Because the decline in fair value is attributable to changes in interest rates and not credit quality these investments were not considered other-than-temporarily impaired at September 30, 2013 and December 31, 2012, respectively.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

The following table presents the components of investment securities gains and losses which have been recognized in earnings.

(in thousands)	Three Months Ended September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Gross gains realized on sales	$ 0	$ 26	$ 554	$ 26
Gross losses realized on sales	0	0	0	0
Other-than-temporary impairment recognized	0	0	0	0
Net realized gains	$ 0	$ 26	$ 554	$ 26

(5) Intangible Assets

Core Deposit Intangible Asset

A summary of amortizable intangible assets at September 30, 2013 and December 31, 2012 is as follows:

(in thousands)	September 30, 2013			December 31, 2012		
	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Core deposit intangible	$ 4,795	$ (4,795)	$ 0	$ 4,795	$ (4,660)	$ 135

Changes in the net carrying amount of core deposit intangible assets for the three and nine months ended September 30, 2013 and 2012 were as follows:

(in thousands)	Three Months Ended September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Balance at beginning of period	$ 0	$ 337	$ 135	$ 543
Additions	0	0	0	0

Amortization	0	(101)	(135)	(307)
Balance at end of period	$ 0	$ 236	$ 0	$ 236

Mortgage Servicing Rights

On January 1, 2012, the Company opted to measure mortgage servicing rights at fair value as permitted by Accounting Standards Codification (ASC) Topic 860-50, *Accounting for Servicing Financial Assets*. The election of this option resulted in the recognition of a cumulative effect of change in accounting principle of $459,890, which was recorded as an increase to beginning retained earnings. As such, effective January 1, 2012, changes in the fair value of mortgage servicing rights have been recognized in earnings in non-interest income in the period in which the change occurred.

At September 30, 2013 and December 31, 2012, respectively, the Company serviced mortgage loans for others totaling $323.0 million and $310.6 million, respectively. Mortgage loan servicing fees, reported as non-interest income, earned on loans sold were $214,000 and $674,000, and $211,000 and $637,000, for the three and nine months ended September 30, 2013 and 2012, respectively.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

The table below presents changes in mortgage servicing rights (MSRs) for the three and nine months ended September 30, 2013 and 2012 as follows:

(in thousands)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Balance at beginning of period	$ 2,873	$ 2,666	$ 2,549	$ 2,308
Re-measurement to fair value upon election to measure servicing rights at fair value	0	0	0	742
Originated mortgage servicing rights	83	231	444	559
Changes in fair value:				
Due to change in model inputs and assumptions (1)	296	96	677	372
Other changes in fair value (2)	(173)	(369)	(591)	(1,357)
Balance at end of period	$ 3,079	$ 2,624	$ 3,079	$ 2,624

(1) The change in fair value resulting from changes in valuation inputs or assumptions used in the valuation model reflects the change in discount rates and prepayment speed assumptions primarily due to changes in interest rates.

(2) Other changes in fair value reflect changes due to customer payments and passage of time. This also includes a one time adjustment of a $538,000 correction of an immaterial prior period error in 2012 due to changing from the straight-line amortization method to an accelerated amortization method of accounting for amortizing MSRs in prior years. If the aforementioned was corrected as of December 31, 2011, the balance at the beginning of the nine month period ending September 30, 2012 would have been $1.8 million.

The following key data and assumptions were used in estimating the fair value of the Company s mortgage servicing rights for the nine months ended September 30, 2013 and 2012:

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Weighted-Average Constant Prepayment Rate	10.94%	16.32%
Weighted-Average Note Rate	4.02%	4.38%
Weighted-Average Discount Rate	8.56%	8.01%

Weighted-Average Expected Life (in years)	5.70	3.90

(6) Income Taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 33.0% for the three months ended September 30, 2013 compared to 30.9% for the three months ended September 30, 2012. Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 31.9% for the nine months ended September 30, 2013 compared to (78.9)% for the nine months ended September 30, 2012. Excluding an immaterial correction of a prior period error of $371,000 and prior year return to provision adjustments, income taxes as a percentage of earnings before income taxes would have been 18.9% for the nine months ended September 30, 2012.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not the Company will realize the benefits of these temporary differences at September 30, 2013 and, therefore, did not establish a valuation reserve.

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

(Unaudited)

(7) Stockholders Equity

Accumulated Other Comprehensive (Loss) Income

The following details the change in the components of the Company s accumulated other comprehensive (loss) income for the nine months ended September 30, 2013:

(in thousands)	Unrealized Gain on Securities	Unrecognized Net Pension and Postretirement Costs	Accumulated Other Comprehensive (Loss) Income
Balance, December 31, 2012	$ 3,265	$ (1,440)	$ 1,825
Reclassification adjustments to net income:			
Realized gain on sale of securities, net of tax	(343)	0	(343)
Other comprehensive (loss) income, net of reclassification and tax	(3,372)	50	(3,322)
Balance, September 30, 2013	$ (450)	$ (1,390)	$ (1,840)

(8) Employee Benefit Plans

Employee Benefits

Employee benefits charged to operating expenses are summarized in the table below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	2013	2012	2013	2012
Payroll taxes	$ 266	$ 278	$ 832	$ 857

Medical plans	483	448	1,443	1,346
401k match and profit-sharing	97	(30)	287	276
Pension plan	286	330	858	990
Other	73	69	153	242
Total employee benefits	$ 1,205	$ 1,095	$ 3,573	$ 3,711

The Company s profit-sharing plan includes a matching 401k portion, in which the Company matches the first 3% of eligible employee contributions. The Company made annual contributions in an amount up to 6% of income before income taxes and before contributions to the profit-sharing and pension plans for all participants, limited to the maximum amount deductible for federal income tax purposes, for each of the periods shown. In addition, employees were able to make additional tax-deferred contributions.

Pension

The Company provides a noncontributory defined benefit pension plan for all full-time employees. An employer is required to recognize the funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. Under the Company s funding policy for the defined benefit pension plan, contributions are made to a trust as necessary to provide for current service and for any unfunded accrued actuarial liabilities over a reasonable period. To the extent that these requirements are fully covered by assets in the trust, a contribution might not be made in a particular year. The Company has not made any contributions to the defined benefit plan for the current plan year through November 14, 2013. The minimum required contribution for the 2013 plan year is estimated to be $665,000. The Company has not determined whether it will make any contributions other than the minimum required funding contribution for 2013.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

Components of Net Pension Cost and Other Amounts Recognized in Accumulated Other Comprehensive (Loss) Income

The following items are components of net pension cost for the periods indicated:

(in thousands)		**Estimated 2013**		**Actual 2012**
Service cost benefits earned during the year	$	1,211	$	1,168
Interest costs on projected benefit obligations		645		668
Expected return on plan assets		(820)		(776)
Expected administrative expenses		0		40
Amortization of prior service cost		78		78
Amortization of unrecognized net loss		30		46
Net periodic pension expense	$	1,144	$	1,224
Pension expense - three months ended September 30, (actual)	$	286	$	330
Pension expense - nine months ended September 30, (actual)	$	858	$	990

(9) Stock Compensation

The Company s stock option plan provides for the grant of options to purchase up to 547,492 shares of the Company s common stock to officers and other key employees of the Company and its subsidiaries. All options have been granted at exercise prices equal to fair value and vest over periods ranging from four to five years, except options issued in 2008 to acquire 11,578 shares that vested immediately.

The following table summarizes the Company s stock option activity:

	Number of Shares	**Weighted Average Exercise Price**	**Weighted Average Contractual Term (in years)**	**Aggregate Intrinsic Value (000)**

Outstanding at beginning of period *	223,951	$ 23.74			
Granted	0	0.00			
Exercised	0	0.00			
Forfeited	0	0.00			
Expired	(36,181)	21.67			
Outstanding at September 30, 2013	187,770	$ 24.13	2.8	$	0
Exercisable at September 30, 2013	173,253	$ 24.31	2.6	$	0

* Options have been adjusted to reflect a 4% stock dividend paid on July 1, 2013.

Total stock-based compensation expense for the three months ended September 30, 2013 and 2012 was $5,000 and $7,000, respectively, and for the nine months ended September 30, 2013 and 2012 was $14,000 and $27,000, respectively. As of September 30, 2013, the total unrecognized compensation expense related to non-vested stock awards was $55,000 and the related weighted average period over which it is expected to be recognized is approximately 2 years.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

(10) Preferred Stock

On December 19, 2008, the Company announced its participation in the U.S. Treasury Department s Capital Purchase Program (CPP), a voluntary program that provides capital to financially healthy banks. This program was designed to attract broad participation by banking institutions to help stabilize the financial system by encouraging lending.

Participating in this program included the Company s issuance of 30,255 shares of senior preferred stock (with a par value of $1,000 per share) and a ten year warrant to purchase approximately 287,133 shares of common stock (see below for additional information) to the U.S. Department of Treasury in exchange for $30.3 million. On May 9, 2012, the Company redeemed 12,000 shares of preferred stock from the U.S. Department of Treasury by repaying $12.0 million of the $30.3 million CPP funds along with $140,000 of accrued and unpaid dividends on the shares redeemed. Related to these shares was an additional $300,000 of accretion that was recognized at the time of the redemption. On May 15, 2013, the Company redeemed the remaining 18,255 shares of preferred stock from the U.S. Department of Treasury by repaying the $18.3 million of the CPP funds along with $228,187 of accrued and unpaid dividends on the shares redeemed. Related to these shares was an additional $182,209 of accretion that was recognized at the time of the redemption.

The common stock warrant was repurchased by the Company on June 11, 2013 pursuant to a letter agreement between the Treasury and the Company for a total repurchase price of $540,000, or $1.88 per warrant share. The repurchase price was based on the fair market value of the warrant as agreed upon by the Company and the Treasury. The repurchase of the warrant ends the Company s participation in the U.S Treasury Department s CPP. For the nine months ended September 30, 2013, the Company had declared and paid $456,000 of dividends and recognized $278,000 of accretion of the discount on preferred stock.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

(11) Earnings per Share

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the year. Diluted earnings per share gives effect to all dilutive potential common shares that were outstanding during the year. The calculations of basic and diluted earnings per share are as follows for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands, except per share data)	**2013**	**2012**	**2013**	**2012**
Basic earnings per common share:				
Net income	$ 1,569	$ (1,572)	$ 3,245	$ 619
Less:				
Preferred stock dividends	0	228	337	894
Accretion of discount on preferred stock	0	72	278	587
Net income available to common shareholders	$ 1,569	$ (1,872)	$ 2,630	$ (862)
Basic earnings per share	$ 0.31	$ (0.37)	$ 0.52	$ (0.17)
Diluted earnings per common share:				
Net income	$ 1,569	$ (1,572)	$ 3,245	$ 619
Less:				
Preferred stock dividends	0	228	337	894
Accretion of discount on preferred stock	0	72	278	587
Net income available to common shareholders	$ 1,569	$ (1,872)	$ 2,630	$ (862)
Average shares outstanding	5,032,679	5,032,679	5,032,679	5,032,679
Effect of dilutive stock options	0	0	0	0
Average shares outstanding including dilutive stock options	5,032,679	5,032,679	5,032,679	5,032,679
Diluted earnings per share	$ 0.31	$ (0.37)	$ 0.52	$ (0.17)

Under the treasury stock method, outstanding stock options are dilutive when the average market price of the Company s common stock, when combined with the effect of any unamortized compensation expense, exceeds the option price during the period, except when the Company has a loss from continuing operations available to common shareholders. In addition, proceeds from the assumed exercise of dilutive options along with the related tax benefit are assumed to be used to repurchase common shares at the average market price of such stock during the period.

The following options to purchase shares during the three and nine months ended September 30, 2013 and 2012 were not included in the respective computations of diluted earnings per share because the exercise price of the option, when combined with the effect of the unamortized compensation expense, was greater than the average market price of the common shares and were considered anti-dilutive. The warrant to purchase common stock was repurchased by the Company on June 11, 2013. See Note 10 for additional information.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Anti-dilutive shares - option shares	187,770	223,951	187,770	223,951
Anti-dilutive shares - warrant shares	0	298,618	0	298,618
Total anti-dilutive shares	187,770	522,569	187,770	522,569

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

(12) Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain financial and nonfinancial assets and liabilities. The FASB ASC Topic 820, *Fair Value Measurements,* defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The standard applies whenever other standards require (permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, FASB clarified the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. As of September 30, 2013 and December 31, 2012, respectively, there were no transfers into or out of Levels 1, Level 2, or Level 3.

The fair value hierarchy is as follows:

Level 1 Inputs are unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2 Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 Inputs are unobservable inputs for the asset or liability and significant to the fair value. These may be internally developed using the Company s best information and assumptions that a market participant would consider.

ASC Topic 820 also provides guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased and on identifying circumstances when a transaction may not be considered orderly.

The Company is required to disclose assets and liabilities measured at fair value on a recurring basis separate from those measured at fair value on a nonrecurring basis. Nonfinancial assets measured at fair value on a nonrecurring basis would include foreclosed real estate, long-lived assets, and core deposit intangible assets, which are reviewed when circumstances or other events indicate that impairment may have occurred.

Valuation methods for instruments measured at fair value on a recurring basis

Following is a description of the Company s valuation methodologies used for assets and liabilities recorded at fair value on a recurring basis:

Available-for-sale securities

The fair value measurements of the Company s investment securities are determined by a third party pricing service which considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond s terms and conditions, among other things. The fair value measurements are subject to independent verification to another pricing source by management each quarter for reasonableness. Securities classified as available-for-sale are reported at fair value utilizing Level 2 inputs, except U.S. Treasury securities which are reported as Level 1.

Mortgage servicing rights

The fair value of mortgage servicing rights is based on the discounted value of estimated future cash flows utilizing contractual cash flows, servicing rate, constant prepayment rate, servicing cost, and discount rate factors. Accordingly, the fair value is estimated based on a valuation model that calculates the present value of estimated future net servicing income. The model incorporates assumptions that market participants use in estimating future net servicing income, including estimates of prepayment speeds, market discount rates, cost to service, float earnings rates, and other ancillary income, including late fees. The valuation models estimate the present value of estimated future net servicing income. The Company classifies its servicing rights as Level 3.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

	Fair Value Measurements		
	Quoted Prices in Active Markets for Identical Assets	Other Observable Inputs	Significant Unobservable