

HAWTHORN BANCSHARES, INC.  
Form 10-Q  
May 15, 2013

**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 March 31, 2013

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: 0-23636

**HAWTHORN BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

**Missouri**  
(State or other jurisdiction of  
incorporation or organization)

**43-1626350**  
(I.R.S. Employer  
Identification No.)

**132 East High Street, Box 688, Jefferson City, Missouri 65102**  
(Address of principal executive offices)

**(573) 761-6100**  
(Registrant's telephone number, including area code)

(Zip 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.  Yes  No

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

As of May 15, 2013, the registrant had 4,839,114 shares of common stock, par value \$1.00 per share, outstanding

**Part I FINANCIAL INFORMATION****Item 1. Financial Statements****HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Balance Sheets (unaudited)**

(In thousands, except per share data)

	March 31, 2013	December 31, 2012
<b>ASSETS</b>		
Cash and due from banks	\$ 19,258	\$ 31,020
Federal funds sold and other overnight interest-bearing deposits	24,604	27,857
Cash and cash equivalents	43,862	58,877
Investment in available-for-sale securities, at fair value	231,991	200,246
Loans	834,256	846,984
Allowances for loan losses	(14,545)	(14,842)
<b>Net loans</b>	<b>819,711</b>	<b>832,142</b>
Premises and equipment net	36,947	37,021
Investments in Federal Home Loan Bank stock and other equity securities, at cost	3,923	3,925
Mortgage servicing rights	2,689	2,549
Other real estate owned and foreclosed assets net	23,128	23,592
Accrued interest receivable	5,023	5,190
Cash surrender value life insurance	2,157	2,136
Other assets	16,888	15,928
<b>Total assets</b>	<b>\$ 1,186,319</b>	<b>\$ 1,181,606</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Deposits		
Non-interest bearing demand	\$ 177,405	\$ 192,271
Savings, interest checking and money market	439,644	405,702
Time deposits \$100,000 and over	119,628	120,777
Other time deposits	263,203	272,525
<b>Total deposits</b>	<b>999,880</b>	<b>991,275</b>
Federal funds purchased and securities sold under agreements to repurchase	17,539	21,058
Subordinated notes	49,486	49,486
Federal Home Loan Bank advances	20,071	20,126
Accrued interest payable	1,102	909
Other liabilities	7,331	6,532
<b>Total liabilities</b>	<b>\$ 1,095,409</b>	<b>\$ 1,089,386</b>
Stockholders equity:		
Preferred stock, \$0.01 par value per share, 1,000,000 shares authorized; Issued 18,255 shares, respectively,		
\$1,000 per share liquidation value, net of discount	18,049	17,977
Common stock, \$1 par value, authorized 15,000,000 shares; Issued 5,000,972 shares, respectively	5,001	5,001

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

Surplus	31,818	31,816
Retained earnings	38,440	39,118
Accumulated other comprehensive income, net of tax	1,119	1,825
Treasury stock; 161,858 shares, at cost	(3,517)	(3,517)
<b>Total stockholders equity</b>	90,910	92,220
<b>Total liabilities and stockholders equity</b>	\$ 1,186,319	\$ 1,181,606

See accompanying notes to the unaudited consolidated financial statements.

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Operations (unaudited)**

<i>(In thousands, except per share amounts)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 10,387	\$ 11,242
Interest on debt securities:		
Taxable	905	1,117
Nontaxable	217	235
Federal funds sold and other overnight interest-bearing deposits	14	21
Dividends on other securities	22	31
<b>Total interest income</b>	<b>11,545</b>	<b>12,646</b>
<b>INTEREST EXPENSE</b>		
Interest on deposits:		
Savings, interest checking and money market	261	325
Time deposit accounts \$100,000 and over	248	229
Other time deposits	883	784
Interest on federal funds purchased and securities sold under agreements to repurchase	5	5
Interest on subordinated notes	320	354
Interest on Federal Home Loan Bank advances	99	134
<b>Total interest expense</b>	<b>1,816</b>	<b>1,831</b>
<b>Net interest income</b>	<b>9,729</b>	<b>10,815</b>
Provision for loan losses	1,000	1,700
<b>Net interest income after provision for loan losses</b>	<b>8,729</b>	<b>9,115</b>
<b>NON INTEREST INCOME</b>		
Service charges on deposit accounts	1,359	1,248
Trust department income	210	212
Real estate servicing fees, net	159	(279)
Gain on sale of mortgage loans, net	720	518
Gain on sale of investment securities	294	0
Other	265	271
<b>Total non interest income</b>	<b>3,007</b>	<b>1,970</b>
<b>NON INTEREST EXPENSE</b>		
Salaries and employee benefits	4,910	4,806
Occupancy expense, net	635	646
Furniture and equipment expense	435	503
FDIC insurance assessment	243	244
Legal, examination, and professional fees	226	337
Advertising and promotion	281	244
Postage, printing, and supplies	256	264
Processing expense	1,275	768
Other real estate expense, net	2,891	581
Other	782	1,087
<b>Total non interest expense</b>	<b>11,934</b>	<b>9,480</b>

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

(Loss) income before income taxes	(198)	1,605
Income tax (benefit) expense	(62)	154
<b>Net (loss) income</b>	<b>(136)</b>	<b>1,451</b>
Preferred stock dividends	223	370
Accretion of discount on preferred stock	72	119
Total preferred stock dividends and accretion of discount on preferred stock	295	489
<b>Net (loss) income available to common shareholders</b>	<b>\$ (431)</b>	<b>\$ 962</b>
Basic (loss) earnings per share	\$ (0.09)	\$ 0.20
Diluted (loss) earnings per share	\$ (0.09)	\$ 0.20

See accompanying notes to the unaudited consolidated financial statements.

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive (Loss) Income** *(unaudited)*

<i>(In thousands)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
Net (loss) income	\$ (136)	\$ 1,451
Other comprehensive loss, net of tax		
Securities available for sale:		
Unrealized loss on investment securities available-for-sale, net of tax	(540)	(79)
Adjustment for gain on sales of investment securities, net of tax	(182)	0
Defined benefit pension plans:		
Amortization of prior service cost included in net periodic pension cost, net of tax	16	26
Total other comprehensive loss	(706)	(53)
Total comprehensive (loss) income	\$ (842)	\$ 1,398

See accompanying notes to the unaudited consolidated financial statements.

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Stockholders Equity (unaudited)**

<i>(In thousands)</i>	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stock - holders Equity
<b>Balance, December 31, 2011</b>	\$ 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
<b>Balance, January 1, 2012</b>	\$ 29,318	\$ 4,815	\$ 30,266	\$ 40,814	\$ 1,340	\$ (3,517)	\$ 103,036
Net income	0	0	0	1,451	0	0	1,451
Other comprehensive loss	0	0	0	0	(53)	0	(53)
Stock based compensation expense	0	0	11	0	0	0	11
Accretion of preferred stock discount	119	0	0	(119)	0	0	0
Cash dividends declared, preferred stock	0	0	0	(378)	0	0	(378)
Cash dividends declared, common stock	0	0	0	(233)	0	0	(233)
<b>Balance, March 31, 2012</b>	\$ 29,437	\$ 4,815	\$ 30,277	\$ 41,535	\$ 1,287	\$ (3,517)	\$ 103,834
<b>Balance, December 31, 2012</b>	\$ 17,977	\$ 5,001	\$ 31,816	\$ 39,118	\$ 1,825	\$ (3,517)	\$ 92,220
Net loss	0	0	0	(136)	0	0	(136)
Other comprehensive loss	0	0	0	0	(706)	0	(706)
Stock based compensation expense	0	0	2	0	0	0	2
Accretion of preferred stock discount	72	0	0	(72)	0	0	0
Cash dividends declared, preferred stock	0	0	0	(228)	0	0	(228)
Cash dividends declared, common stock	0	0	0	(242)	0	0	(242)
<b>Balance, March 31, 2013</b>	\$ 18,049	\$ 5,001	\$ 31,818	\$ 38,440	\$ 1,119	\$ (3,517)	\$ 90,910

See accompanying notes to the unaudited consolidated financial statements.



**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (unaudited)**

<i>(In thousands)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Cash flows from operating activities:</b>		
Net (loss) income	\$ (136)	\$ 1,451
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,000	1,700
Depreciation expense	400	502
Net amortization of investment securities, premiums, and discounts	343	247
Amortization of intangible assets	101	104
Stock based compensation expense	2	10
Change in fair value of mortgage servicing rights	57	485
Gain on sale of investment securities	(294)	0
Gain on sales and dispositions of premises and equipment	0	(44)
Gain on sales and dispositions of other real estate owned and foreclosed assets	(13)	(8)
Provision for other real estate owned	2,343	254
Decrease in accrued interest receivable	167	366
Increase in cash surrender value life insurance	(21)	(20)
(Increase) decrease in other assets	(476)	405
(Increase) decrease) in income tax receivable	(68)	295
Increase in accrued interest payable	193	143
Increase in other liabilities	800	628
Origination of mortgage loans for sale	(26,463)	(22,376)
Proceeds from the sale of mortgage loans	29,290	21,815
Gain on sale of mortgage loans, net	(720)	(519)
Other, net	(170)	(139)
<b>Net cash provided by operating activities</b>	<b>6,335</b>	<b>5,299</b>
<b>Cash flows from investing activities:</b>		
Net decrease (increase) in loans	6,854	(2,396)
Purchase of available-for-sale debt securities	(62,541)	(41,291)
Proceeds from maturities of available-for-sale debt securities	11,260	12,053
Proceeds from calls of available-for-sale debt securities	2,255	13,515
Proceeds from sales of available-for-sale debt securities	15,981	0
Proceeds from sales of FHLB stock	2	53
Purchases of premises and equipment	(326)	(552)
Proceeds from sales of premises and equipment	0	45
Proceeds from sales of other real estate owned and foreclosed assets	604	1,195
<b>Net cash used by investing activities</b>	<b>(25,911)</b>	<b>(17,378)</b>
<b>Cash flows from financing activities:</b>		
Net (decrease) increase in demand deposits	(14,866)	7,289
Net increase in interest-bearing transaction accounts	33,942	31,652
Net decrease in time deposits	(10,471)	(4,061)
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(3,519)	(1,768)
Repayment of Federal Home Loan Bank advances	(55)	(65)
Cash dividends paid preferred stock	(228)	(378)
Cash dividends paid common stock	(242)	(233)
<b>Net cash provided by financing activities</b>	<b>4,561</b>	<b>32,436</b>

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

Net (decrease) increase in cash and cash equivalents	(15,015)	20,357
Cash and cash equivalents, beginning of period	58,877	43,210
<b>Cash and cash equivalents, end of period</b>	<b>\$ 43,862</b>	<b>\$ 63,567</b>

See accompanying notes to the consolidated financial statements.

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (continued) (unaudited)**

<i>(In thousands)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the year for:		
Interest	\$ 1,624	\$ 2,057
Income taxes	\$ 6	\$ 790
<b>Supplemental schedule of noncash investing and financing activities:</b>		
Other real estate and repossessions acquired in settlement of loans	\$ 2,470	\$ 5,598
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.

**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 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 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.

**Stock Dividend** On July 1, 2012, the Company paid a special stock dividend of four percent to common shareholders of record at the close of business on June 15, 2012. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.



## 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 March 31, 2013 and December 31, 2012 is as follows:

<i>(in thousands)</i>	March 31, 2013	December 31, 2012
Commercial, financial, and agricultural	\$ 127,014	\$ 130,040
Real estate construction residential	22,568	22,177
Real estate construction commercial	46,367	43,486
Real estate mortgage residential	215,919	221,223
Real estate mortgage commercial	398,555	405,092
Installment and other consumer	23,833	24,966
<b>Total loans</b>	<b>\$ 834,256</b>	<b>\$ 846,984</b>

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 March 31, 2013, loans with a carrying value of \$422,524,000 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 months ended March 31, 2013, and 2012:

<i>(in thousands)</i>	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
<b>Balance at December 31, 2012</b>	<b>\$ 1,937</b>	<b>\$ 732</b>	<b>\$ 1,711</b>	<b>\$ 3,387</b>	<b>\$ 6,834</b>	<b>\$ 239</b>	<b>\$ 2</b>	<b>\$ 14,842</b>
Additions:								
Provision for loan losses	(90)	287	100	(189)	844	47	1	1,000
Deductions:								
Loans charged off	61	120	0	292	999	109	0	1,581
Less recoveries on loans	(42)	0	0	(15)	(161)	(66)	0	(284)
<b>Net loans charged off</b>	<b>19</b>	<b>120</b>	<b>0</b>	<b>277</b>	<b>838</b>	<b>43</b>	<b>0</b>	<b>1,297</b>
<b>Balance at March 31, 2013</b>	<b>\$ 1,828</b>	<b>\$ 899</b>	<b>\$ 1,811</b>	<b>\$ 2,921</b>	<b>\$ 6,840</b>	<b>\$ 243</b>	<b>\$ 3</b>	<b>\$ 14,545</b>

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

<b>Balance at December 31, 2011</b>	<b>\$ 1,804</b>	<b>\$ 1,188</b>	<b>\$ 1,562</b>	<b>\$ 3,251</b>	<b>\$ 5,734</b>	<b>\$ 267</b>	<b>\$ 3</b>	<b>\$ 13,809</b>
Additions:								
Provision for loan losses	867	(493)	(152)	415	1,027	34	2	1,700
Deductions:								
Loans charged off	35	0	0	155	862	139	0	1,191
Less recoveries on loans	(86)	(32)	0	(52)	(77)	(75)	0	(322)
<b>Net loans charged off</b>	<b>(51)</b>	<b>(32)</b>	<b>0</b>	<b>103</b>	<b>785</b>	<b>64</b>	<b>0</b>	<b>869</b>
<b>Balance at March 31, 2012</b>	<b>\$ 2,722</b>	<b>\$ 727</b>	<b>\$ 1,410</b>	<b>\$ 3,563</b>	<b>\$ 5,976</b>	<b>\$ 237</b>	<b>\$ 5</b>	<b>\$ 14,640</b>

Loans, or portions of loans, are charged off to the extent deemed uncollectible. 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

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

conditions and loss experience, specific reserves are estimated as further discussed below. Loans not individually evaluated are aggregated 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 is 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 March 31, 2013 and December 31, 2012, and the related loan balance by impairment methodology.

<i>(in thousands)</i>	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
<b>March 31, 2013</b>								
<b>Allowance for loan losses:</b>								
Individually evaluated for impairment	\$ 229	\$ 294	\$ 534	\$ 1,133	\$ 1,896	\$ 6	\$ 0	\$ 4,092
Collectively evaluated for impairment	1,599	605	1,277	1,788	4,944	237	3	10,453
<b>Total</b>	<b>\$ 1,828</b>	<b>\$ 899</b>	<b>\$ 1,811</b>	<b>\$ 2,921</b>	<b>\$ 6,840</b>	<b>\$ 243</b>	<b>\$ 3</b>	<b>\$ 14,545</b>
<b>Loans outstanding:</b>								
Individually evaluated for impairment	\$ 3,743	\$ 2,589	\$ 8,689	\$ 5,980	\$ 17,418	\$ 44	\$ 0	\$ 38,463
Collectively evaluated for impairment	123,271	19,979	37,678	209,939	381,137	23,789	0	795,793
<b>Total</b>	<b>\$ 127,014</b>	<b>\$ 22,568</b>	<b>\$ 46,367</b>	<b>\$ 215,919</b>	<b>\$ 398,555</b>	<b>\$ 23,833</b>	<b>\$ 0</b>	<b>\$ 834,256</b>
<b>December 31, 2012</b>								
<b>Allowance for loan losses:</b>								
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
<b>Total</b>	<b>\$ 1,937</b>	<b>\$ 732</b>	<b>\$ 1,711</b>	<b>\$ 3,387</b>	<b>\$ 6,834</b>	<b>\$ 239</b>	<b>\$ 2</b>	<b>\$ 14,842</b>
<b>Loans outstanding:</b>								
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
<b>Total</b>	<b>\$ 130,040</b>	<b>\$ 22,177</b>	<b>\$ 43,486</b>	<b>\$ 221,223</b>	<b>\$ 405,092</b>	<b>\$ 24,966</b>	<b>\$ 0</b>	<b>\$ 846,984</b>



*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 \$38,622,000 and \$39,363,000 at March 31, 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 \$38,622,000 at March 31, 2013, includes \$38,463,000 of impaired loans individually evaluated for impairment and \$159,000 of non-accrual consumer loans that were collectively evaluated for impairment. Total impaired loans of \$39,363,000 at December 31, 2012, includes \$39,189,000 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. Once the impairment amount is calculated, a specific reserve allocation is recorded. At March 31, 2013, \$4,092,000 of the Company's allowance for loan losses was allocated to impaired loans totaling approximately \$38,622,000 compared to \$4,020,000 of the Company's allowance for loan losses allocated to impaired loans totaling approximately \$39,363,000 at December 31, 2012. Management determined that \$12,892,000, or 33%, of total impaired loans required no reserve allocation at March 31, 2013 compared to \$14,733,000, or 37%, at December 31, 2012 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

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 is 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 three year 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 March 31, 2013 and December 31, 2012 are as follows:

<i>(in thousands)</i>	March 31, 2013	December 31, 2012
Non-accrual loans	\$ 30,650	\$ 31,081
Troubled debt restructurings continuing to accrue interest	7,972	8,282
<b>Total impaired loans</b>	<b>\$ 38,622</b>	<b>\$ 39,363</b>

The following tables provide additional information about impaired loans at March 31, 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.

<i>(in thousands)</i>	Recorded Investment	Unpaid Principal Balance	Specific Reserves
<b>March 31, 2013</b>			
<b>With no related allowance recorded:</b>			
Commercial, financial and agricultural	\$ 2,777	\$ 2,887	\$ 0
Real estate construction residential	336	369	0
Real estate construction commercial	2,393	2,616	0
Real estate residential	2,073	2,731	0
Real estate commercial	5,154	5,470	0
Consumer	159	182	0
<b>Total</b>	<b>\$ 12,892</b>	<b>\$ 14,255</b>	<b>\$ 0</b>
<b>With an allowance recorded:</b>			
Commercial, financial and agricultural	\$ 966	\$ 985	\$ 229
Real estate construction residential	2,253	2,273	294
Real estate construction commercial	6,296	6,444	534
Real estate residential	3,907	4,053	1,133

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

Real estate commercial	12,264	13,298	1,896
Consumer	44	45	6
<b>Total</b>	<b>\$ 25,730</b>	<b>\$ 27,098</b>	<b>\$ 4,092</b>
<b>Total impaired loans</b>	<b>\$ 38,622</b>	<b>\$ 41,353</b>	<b>\$ 4,092</b>

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

<i>(in thousands)</i>	Recorded Investment	Unpaid Principal Balance	Specific Reserves
<b>December 31, 2012</b>			
<b>With no related allowance recorded:</b>			
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
<b>Total</b>	<b>\$ 14,733</b>	<b>\$ 16,594</b>	<b>\$ 0</b>
<b>With an allowance recorded:</b>			
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
<b>Total</b>	<b>\$ 24,630</b>	<b>\$ 25,308</b>	<b>\$ 4,020</b>
<b>Total impaired loans</b>	<b>\$ 39,363</b>	<b>\$ 41,902</b>	<b>\$ 4,020</b>

The following table presents by class, information related to the average recorded investment and interest income recognized on impaired loans for the three months ended March 31, 2013 and 2012.

<i>(in thousands)</i>	Three Months Ended March 31,			
	2013	Interest Recognized For the Period Ended	2012	Interest Recognized For the Period Ended
	Average Recorded Investment		Average Recorded Investment	
<b>With no related allowance recorded:</b>				
Commercial, financial and agricultural	\$ 2,937	\$ 25	\$ 3,594	\$ 22
Real estate construction residential	369	0	417	7
Real estate construction commercial	2,616	0	1,440	0
Real estate residential	2,736	0	2,349	2
Real estate commercial	5,480	29	11,918	32
Consumer	189	0	160	0
<b>Total</b>	<b>\$ 14,327</b>	<b>\$ 54</b>	<b>\$ 19,878</b>	<b>\$ 63</b>
<b>With an allowance recorded:</b>				

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

Commercial, financial and agricultural	\$ 990	\$ 7	\$ 1,752	\$ 7
Real estate construction residential	2,273	0	189	0
Real estate construction commercial	6,475	1	6,330	0
Real estate residential	4,082	20	4,729	30
Real estate commercial	13,634	26	16,575	0
Consumer	45	0	0	0
<b>Total</b>	<b>\$ 27,499</b>	<b>\$ 54</b>	<b>\$ 29,575</b>	<b>\$ 37</b>
<b>Total impaired loans</b>	<b>\$ 41,826</b>	<b>\$ 108</b>	<b>\$ 49,453</b>	<b>\$ 100</b>

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 \$108,000 and \$100,000, for the three months ended March 31, 2013 and 2012, respectively. The average recorded investment in impaired loans is calculated on a monthly basis during the periods reported. Contractual interest due on loans in non-accrual status was \$350,000 at March 31, 2013 compared to \$626,000 at March 31, 2012. During the three months ended March 31, 2013, \$7,000 in interest was recognized on loans in non-accrual status on a cash basis. During the three months ended March 31, 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 March 31, 2013 and December 31, 2012.

	Current or Less Than 30 Days Past Due	30 - 89 Days Past Due	90 Days Past Due And Still Accruing	Non-Accrual	Total
<i>(in thousands)</i>					
<b>March 31, 2013</b>					
Commercial, Financial, and Agricultural	\$ 125,064	\$ 752	\$ 0	\$ 1,198	\$ 127,014
Real Estate Construction Residential	19,979	0	0	2,589	22,568
Real Estate Construction Commercial	37,054	624	0	8,689	46,367
Real Estate Mortgage Residential	208,611	2,384	0	4,924	215,919
Real Estate Mortgage Commercial	383,485	2,023	0	13,047	398,555
Installment and Other Consumer	23,215	414	1	203	23,833
<b>Total</b>	<b>\$ 797,408</b>	<b>\$ 6,197</b>	<b>\$ 1</b>	<b>\$ 30,650</b>	<b>\$ 834,256</b>
<b>December 31, 2012</b>					
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
<b>Total</b>	<b>\$ 809,338</b>	<b>\$ 6,559</b>	<b>\$ 6</b>	<b>\$ 31,081</b>	<b>\$ 846,984</b>

*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 exists; 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 March 31, 2013 and December 31, 2012.

<i>(in thousands)</i>	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment and other Consumer	Total
<b>At March 31, 2013</b>							
Watch	\$ 16,294	\$ 4,435	\$ 5,742	\$ 25,618	\$ 28,429	\$ 606	\$ 81,124
Substandard	7,315	93	2,353	5,678	9,797	606	25,842
Non-accrual	1,198	2,589	8,689	4,924	13,047	203	30,650
<b>Total</b>	<b>\$ 24,807</b>	<b>\$ 7,117</b>	<b>\$ 16,784</b>	<b>\$ 36,220</b>	<b>\$ 51,273</b>	<b>\$ 1,415</b>	<b>\$ 137,616</b>

**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
<b>Total</b>	<b>\$ 22,634</b>	<b>\$ 7,473</b>	<b>\$ 16,256</b>	<b>\$ 36,865</b>	<b>\$ 54,718</b>	<b>\$ 1,314</b>	<b>\$ 139,260</b>

*Troubled Debt Restructurings*

At March 31, 2013, loans classified as troubled debt restructurings (TDRs) totaled \$22,314,000, of which \$14,341,000 was on non-accrual status and \$7,973,000 was on accrual status. At December 31, 2012, loans classified as TDRs totaled \$22,363,000, of which \$14,081,000 was on non-accrual status and \$8,282,000 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 \$1,718,000 and \$1,544,000 related to TDRs were allocated to the allowance for loan losses at March 31, 2013 and December 31, 2012, respectively.

The following table summarizes loans that were modified as TDRs during the three months ended March 31, 2013 and 2012.

<i>(in thousands)</i>	Three Months Ended March 31,					
	2013			2012		
	Number of Contracts	Recorded Pre- Investment(1) Modification	Post- Investment(1) Modification	Number of Contracts	Recorded Pre- Investment(1) Modification	Post- Investment(1) Modification
<b>Troubled Debt Restructurings</b>						
Commercial, financial and agricultural	0	\$ 0	\$ 0	1	\$ 196	\$ 196
Real estate construction commercial	0	0	0	1	43	43
Real estate mortgage residential	1	619	619	0	0	0
<b>Total</b>	<b>1</b>	<b>\$ 619</b>	<b>\$ 619</b>	<b>2</b>	<b>\$ 239</b>	<b>\$ 239</b>



- (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. 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 three months ended March 31, 2013, one loan meeting the TDR criteria was modified. There were no loans modified as a TDR that defaulted during the three months ended March 31, 2013, and within twelve months of their modification date. No loans modified as a TDR during the three months ended March 31, 2012 defaulted.

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

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

<i>(in thousands)</i>	March 31, 2013	December 31, 2012
Commercial	\$ 312	\$ 329
Real estate construction residential	170	112
Real estate construction commercial	13,400	13,392
Real estate mortgage residential	1,353	1,227
Real estate mortgage commercial	15,771	14,201
Foreclosed assets	466	468
<b>Total</b>	<b>\$ 31,472</b>	<b>\$ 29,729</b>
Less valuation allowance for other real estate owned	(8,344)	(6,137)
<b>Total other real estate owned and foreclosed assets</b>	<b>\$ 23,128</b>	<b>\$ 23,592</b>

Changes in the net carrying amount of other real estate owned and foreclosed assets for the three months ended March 31, 2013 and 2012 were as follows:

	Three Months Ended March 31,	
	2013	2012
<b>Balance at beginning of period</b>	<b>\$ 29,729</b>	<b>\$ 22,997</b>
Additions	2,470	5,598
Proceeds from sales	(604)	(1,195)
Charge-offs against the valuation allowance for other real estate owned, net	(136)	(41)
Net gain on sales	13	8
<b>Total other real estate owned and repossessed assets</b>	<b>\$ 31,472</b>	<b>\$ 27,367</b>
Less valuation allowance for other real estate owned	(8,344)	(7,190)
<b>Balance at end of period</b>	<b>\$ 23,128</b>	<b>\$ 20,177</b>

Activity in the valuation allowance for other real estate owned in settlement of loans for the three months ended March 31, 2013 and 2012, respectively, is summarized as follows:

<i>(in thousands)</i>	Three Months Ended March 31,	
	2013	2012
<b>Balance, beginning of year</b>	<b>\$ 6,137</b>	<b>\$ 6,977</b>
Provision for other real estate owned	2,343	254

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

Charge-offs	(136)	(41)
<b>Balance, end of year</b>	\$ 8,344	\$ 7,190

The significant change in the expense provision from the three months ended March 31, 2012 to the three months ended March 31, 2013, primarily related to foreclosed commercial real estate property consisting of two hotels in the Branson area due to continued deterioration of value. These amounts are reflected in other real estate expense in the consolidated statements of operations.

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

**(4) Investment Securities**

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

<i>(in thousands)</i>	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
<b>March 31, 2013</b>				
U.S. Treasury	\$ 2,000	\$ 23	\$ 0	\$ 2,023
Government sponsored enterprises	68,869	728	21	69,576
Asset-backed securities	122,624	2,594	300	124,918
Obligations of states and political subdivisions	34,396	1,119	41	35,474
<b>Total available for sale securities</b>	<b>\$ 227,889</b>	<b>\$ 4,464</b>	<b>\$ 362</b>	<b>\$ 231,991</b>
<b>December 31, 2012</b>				
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
<b>Total available for sale securities</b>	<b>\$ 194,893</b>	<b>\$ 5,381</b>	<b>\$ 28</b>	<b>\$ 200,246</b>

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 \$3,923,000 and \$3,925,000 as of March 31, 2013 and December 31, 2012, respectively.

Debt securities with carrying values aggregating approximately \$167,661,000 and \$146,442,000 at March 31, 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.

The amortized cost and fair value of debt securities classified as available-for-sale at March 31, 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.

<i>(in thousands)</i>	Amortized cost	Fair value
Due in one year or less	\$ 4,925	\$ 4,992
Due after one year through five years	62,579	63,740

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

Due after five years through ten years	36,614	37,214
Due after ten years	1,147	1,127
<b>Total</b>	<b>105,265</b>	<b>107,073</b>
Asset-backed securities	122,624	124,918
<b>Total available for sale securities</b>	<b>\$ 227,889</b>	<b>\$ 231,991</b>

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

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 March 31, 2013 and December 31, 2012, were as follows:

<i>(in thousands)</i>	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>At March 31, 2013</b>						
Government sponsored enterprises	\$ 20,569	\$ (21)	\$ 0	\$ 0	\$ 20,569	\$ (21)
Asset-backed securities	42,235	(290)	892	(10)	43,127	(300)
Obligations of states and political subdivisions	3,802	(41)	0	0	3,802	(41)
<b>Total</b>	<b>\$ 66,606</b>	<b>\$ (352)</b>	<b>\$ 892</b>	<b>\$ (10)</b>	<b>\$ 67,498</b>	<b>\$ (362)</b>

*(in thousands)***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)
<b>Total</b>	<b>\$ 7,887</b>	<b>\$ (28)</b>	<b>\$ 150</b>	<b>\$ 0</b>	<b>\$ 8,037</b>	<b>\$ (28)</b>

The total available for sale portfolio consisted of approximately 403 securities at March 31, 2013. The portfolio included 47 securities, having an aggregate fair value of \$67,498,000 that were in a loss position at March 31, 2013. Securities identified as temporarily impaired which have been in a loss position for 12 months or longer totaled \$892,000 at fair value. The \$10,000 unrealized loss included in other comprehensive income at March 31, 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 \$8,037,000 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 \$98 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 March 31, 2013 and December 31, 2012, respectively.

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

<i>(in thousands)</i>	Three Months Ended	
	March 31,	
	2013	2012
Gross gains realized on sales	\$ 294	\$ 0
Gross losses realized on sales	0	0
Other-than-temporary impairment recognized	0	0
<b>Net realized gains</b>	<b>\$ 294</b>	<b>\$ 0</b>



**HAWTHORN BANCSHARES, INC.****AND SUBSIDIARIES**

## Notes to the Consolidated Financial Statements

*(Unaudited)***(5) Intangible Assets***Core Deposit Intangible Asset*

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

<i>(in thousands)</i>	March 31, 2013			December 31, 2012		
	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Core deposit intangible	\$ 4,795	\$ (4,761)	\$ 34	\$ 4,795	\$ (4,660)	\$ 135

The Company's core deposit intangible asset will be fully amortized in April 2013.

Changes in the net carrying amount of core deposit intangible assets for the three months ended March 31, 2013 and 2012 were as follows:

<i>(in thousands)</i>	Three Months Ended March 31,	
	2013	2012
<b>Balance at beginning of year</b>	\$ 135	\$ 543
Additions	0	0
Amortization	(101)	(104)
<b>Balance at end of year</b>	\$ 34	\$ 439

*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 noninterest income in the period in which the change occurred.

At March 31, 2013 and December 31, 2012, respectively, the Company serviced mortgage loans for others totaling \$318,894,000 and \$310,587,000, respectively. Mortgage loan servicing fees, reported as other noninterest income, earned on loans sold were \$217,000 and \$207,000 for the three months ended March 31, 2013 and 2012, respectively.

The table below presents changes in mortgage servicing rights (MSRs) for the three months ended March 31, 2013 and 2012 as follows:

<i>(in thousands)</i>	Three Months Ended March 31,	
	2013	2012



Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

<b>Balance at beginning of period</b>	\$ 2,549	\$ 2,308
Re-measurement to fair value upon election to measure servicing rights at fair value	0	742
Originated mortgage servicing rights	197	182
Changes in fair value:		
Due to change in model inputs and assumptions(1)	194	170
Other changes in fair value(2)	(251)	(655)
<b>Balance at end of period</b>	\$ 2,689	\$ 2,747

- (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.

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

- (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 three month period ending March 31, 2012 would have been \$1,770,000. The following key data and assumptions were used in estimating the fair value of the Company's mortgage servicing rights for the three months ended March 31, 2013 and 2012:

	Three Months Ended March 31,	
	2013	2012
Weighted-Average Constant Prepayment Rate	17.63%	17.78%
Weighted-Average Note Rate	4.12%	4.55%
Weighted-Average Discount Rate	8.03%	8.01%
Weighted-Average Contractual Life (in years)	20.00	20.00

**(6) Income Taxes**

Income taxes as a percentage of earnings (loss) before income taxes as reported in the consolidated financial statements were 31.3% for the three months ended March 31, 2013 compared to 9.6% for the three months ended March 31, 2012. Excluding an immaterial correction of a prior period error of \$371,000, income taxes as a percentage of earnings before income taxes would have been 32.8% for the three months ended March 31, 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 March 31, 2013 and, therefore, did not establish a valuation reserve.

**(7) Stockholders Equity***Accumulated Other Comprehensive Income*

The following details the change in the components of the Company's accumulated other comprehensive income for the three months ended March 31, 2013:

<i>(in thousands)</i>	Unrealized Gain	Unrecognized Net	Accumulated
	on Securities	Pension and Postretirement Costs	Other Comprehensive Income
<b>Balance, December 31, 2012</b>	\$ 3,265	\$ (1,440)	\$ 1,825
Reclassification adjustments to net income:			
Realized gain on sale of securities, net of tax	(182)	0	(182)
Other comprehensive income, net of reclassification and tax	(540)	16	(524)

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

<b>Balance, March 31, 2013</b>	\$	2,543	\$	(1,424)	\$	1,119
--------------------------------	----	-------	----	---------	----	-------

**HAWTHORN BANCSHARES, INC.****AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)***(8) Employee Benefit Plans***Employee Benefits*

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

<i>(in thousands)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
Payroll taxes	\$ 304	\$ 295
Medical plans	491	458
401k match and profit-sharing	75	168
Pension plan	286	330
Other	47	49
<b>Total employee benefits</b>	<b>\$ 1,203</b>	<b>\$ 1,300</b>

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 through May 15, 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.

*Components of Net Pension Cost and Other Amounts Recognized in Accumulated Other Comprehensive Income*

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

<i>(in thousands)</i>	<b>Estimated</b>	<b>Actual</b>
	<b>2013</b>	<b>2012</b>
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

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

<b>Net periodic pension expense</b>	\$ 1,144	\$ 1,224
Pension expense three months ended March 31, (actual)	\$ 286	\$ 330

**HAWTHORN BANCSHARES, INC.****AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)***(9) Stock Compensation**

The Company's stock option plan provides for the grant of options to purchase up to 526,435 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 11,133 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*	215,343	\$ 24.68		
Granted	0	0.00		
Exercised	0	0.00		
Forfeited	0	0.00		
Expired	(34,097)	22.62		
Outstanding at March 31, 2013	181,246	\$ 25.07	3.3	\$ 0
Exercisable at March 31, 2013	165,350	\$ 25.21	3.1	\$ 0

\* Options have been adjusted to reflect a 4% stock dividend paid on July 1, 2012.

Total stock-based compensation expense for the three months ended March 31, 2013 and 2012 was \$2,000 and \$11,000, respectively. As of March 31, 2013, the total unrecognized compensation expense related to non-vested stock awards was \$66,000 and the related weighted average period over which it is expected to be recognized is approximately 2 years.

**(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 \$30,255,000. The proceeds received were allocated between the preferred stock and the common stock warrant based upon their relative fair values. This resulted in the recording of a discount on the preferred stock upon issuance that reflects the value allocated to the warrant. The discount on the preferred stock will be accreted over five years, consistent with management's estimate of the life of the preferred stock. Such accretion will be treated as additional dividends on the preferred stock. On May 9, 2012, the Company redeemed 12,000 shares of preferred stock from the U.S. Department of Treasury by repaying \$12,000,000 of the \$30,255,000 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. The Company has approval and will redeem the remaining 18,255 shares on May 15, 2013. The

## Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

allocated carrying values of the senior preferred stock and common stock warrant at March 31, 2013 were \$18,049,000 and \$2,382,000, respectively.

The common stock warrant is exercisable immediately with a ten year term, in whole or in part, at an exercise price of \$15.81 per share. The preferred stock and warrant are classified as stockholders' equity in the consolidated balance sheets and qualify, for regulatory capital purposes, as Tier I capital. For the three months ended March 31, 2013, the Company had declared and paid \$223,000 of dividends and recognized \$72,000 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:

	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Basic (loss) earnings per common share:</b>		
<b>Net (loss) income</b>	\$ (136,549)	\$ 1,450,735
Less:		
Preferred stock dividends	223,117	369,783
Accretion of discount on preferred stock	71,873	119,119
Net (loss) income available to common shareholders	\$ (431,539)	\$ 961,833
<b>Basic (loss) earnings per share</b>	<b>\$ (0.09)</b>	<b>\$ 0.20</b>
<b>Diluted (loss) earnings per common share:</b>		
<b>Net (loss) income</b>	\$ (136,549)	\$ 1,450,735
Less:		
Preferred stock dividends	223,117	369,783
Accretion of discount on preferred stock	71,873	119,119
Net (loss) income available to common shareholders	\$ (431,539)	\$ 961,833
Average shares outstanding	4,839,114	4,839,114
Effect of dilutive stock options	0	0
Average shares outstanding including dilutive stock options	4,839,114	4,839,114
<b>Diluted (loss) earnings per share</b>	<b>\$ (0.09)</b>	<b>\$ 0.20</b>

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 months ended March 31, 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.

Three Months Ended March 31,



Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

	2013	2012
Anti-dilutive shares    option shares	181,246	232,678
Anti-dilutive shares    warrant shares	287,133	287,133
<b>Total anti-dilutive shares</b>	<b>468,379</b>	<b>519,811</b>

---

**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 March 31, 2013 and December 31, 2012, respectively, there were no transfers into or out of Levels 1-3.

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)

(in thousands)	Fair Value	Fair Value Measurements		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>March 31, 2013</b>				
<b>Assets:</b>				
U.S. treasury	\$ 2,023	\$ 2,023	\$ 0	\$ 0
Government sponsored enterprises	69,576	0	69,576	0
Asset-backed securities	124,918	0	124,918	0
Obligations of states and political subdivisions	35,474	0	35,474	0
Mortgage servicing rights	2,689	0	0	2,689
Total	\$ 234,680	\$ 2,023	\$ 229,968	\$ 2,689
<b>December 31, 2012</b>				
<b>Assets:</b>				
U.S. treasury	\$ 2,030	\$ 2,030	\$ 0	\$ 0
Government sponsored enterprises	55,180	0	55,180	0
Asset-backed securities	107,872	0	107,872	0
Obligations of states and political subdivisions	35,164	0	35,164	0
Mortgage servicing rights	2,549	0	0	2,549
Total	\$ 202,795	\$ 2,030	\$ 198,216	\$ 2,549

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the three months ended March 31, 2013 and 2012 are summarized as follows:

(in thousands)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	Mortgage Servicing Rights Three Months Ended March 31, 2013	2012
Balance at beginning of period	\$ 2,549	\$ 0
Transfer into level 3	0	3,050
Total gains or losses (realized/unrealized):		
Included in earnings	(57)	(485)
Included in other comprehensive income	0	0
Purchases	0	0

Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

Sales	0	0
Issued	197	182
Settlements	0	0
Balance at end of period	\$ 2,689	\$ 2,747

Total gains for the three months ended included in earnings attributable to the change in unrealized gains or losses related to assets still held were \$194,000 and \$170,000 at March 31, 2013 and 2012, respectively.

**HAWTHORN BANCSHARES, INC.****AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

Quantitative Information about Level 3 Fair Value Measurements			Input Value	
Valuation Technique	Unobservable Inputs		Three Months Ended March 31, 2013	2012
Mortgage servicing rights	Discounted cash flows	Weighted average constant prepayment rate	17.63%	17.78%
		Weighted average discount rate	8.03%	8.01%

**Valuation methods for instruments measured at fair value on a nonrecurring basis**

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

*Impaired Loans*

The Company does not record loans at fair value on a recurring basis other than loans that are considered impaired. The net carrying value of impaired loans is generally based on fair values of the underlying collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. Once the fair value of the collateral has been determined and any impairment amount calculated, a specific reserve allocation is made. Because many of these inputs are not observable, the measurements are classified as Level 3. As of March 31, 2013, our Company identified \$25.7 million of impaired loans that had specific allowances for losses aggregating \$4.1 million.

*Other Real Estate Owned and Repossessed Assets*

Other real estate owned and repossessed assets consist of loan collateral that has been repossessed through foreclosure. This collateral comprises of commercial and residential real estate and other non-real estate property, including autos, manufactured homes, and construction equipment. Other real estate owned assets are recorded as held for sale initially at the lower of the loan balance or fair value of the collateral less estimated selling costs. The Company relies on external appraisals and assessment of property values by internal staff. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgment based on experience and expertise of internal specialists. Subsequent to foreclosure, valuations are updated periodically, and the assets may be written down to reflect a new cost basis. Because many of these inputs are not observable, the measurements are classified as Level 3.

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

For assets measured at fair value on a nonrecurring basis during the first three months of 2013 and 2012, and still held as of March 31, 2013 and 2012, the following table provides the adjustments to fair value recognized during the respective periods, the level of valuation inputs used to determine each adjustment, and the carrying value of the related individual assets or portfolios at March 31, 2013 and 2012.

	Fair Value Measurements Using				Three Months Ended March 31, Total Gains (Losses)*
	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<i>(in thousands)</i>					
<b>March 31, 2013</b>					
<b>Assets:</b>					
Impaired loans:					
Commercial, financial, & agricultural	\$ 737	\$ 0	\$ 0	\$ 737	\$ (10)
Real estate construction residential	1,959	0	0	1,959	(119)
Real estate construction commercial	5,762	0	0	5,762	0
Real estate mortgage residential	2,774	0	0	2,774	(235)
Real estate mortgage commercial	10,368	0	0	10,368	(987)
Consumer	38	0	0	38	0
Total	\$ 21,638	\$ 0	\$ 0	\$ 21,638	\$ (1,351)
Other real estate owned and repossessed assets	\$ 23,128	\$ 0	\$ 0	\$ 23,128	\$ (200)
<b>March 31, 2012</b>					
<b>Assets:</b>					
Impaired loans:					
Commercial, financial, & agricultural	\$ 1,715	\$ 0	\$ 0	\$ 1,715	\$ (35)
Real estate construction residential	130	0	0	130	0
Real estate construction commercial	5,801	0	0	5,801	0
Real estate mortgage residential	3,849	0	0	3,849	(124)
Real estate mortgage commercial	14,593	0	0	14,593	(588)
Consumer	0	0	0	0	0
Total	\$ 26,088	\$ 0	\$ 0	\$ 26,088	\$ (747)
Other real estate owned and repossessed assets	\$ 20,177	\$ 0	\$ 0	\$ 20,177	\$ (270)

\* Total gains (losses) reported for other real estate owned and repossessed assets includes charge-offs, valuation write downs, and net losses taken during the periods reported.

**(13) Fair Value of Financial Instruments**

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate such value:

***Loans***

The fair values of loans are estimated by discounting the expected future cash flows using the current rates at which similar loans could be made to borrowers with similar credit ratings and for the same remaining maturities. The net carrying amount 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. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC Topic 820.

***Investment in available-for-sale securities***

A detailed description of the fair value measurement of the debt instruments in the available-for-sale sections of the investment security portfolio is provided in the *Fair Value Measurement* section above. A schedule of investment securities by category and maturity is provided in the notes on *Investment Securities*.



---

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

***Federal Home Loan Bank (FHLB) Stock***

Ownership of equity securities of FHLB is restricted and there is no established market for their resale. The carrying amount is a reasonable estimate of fair value as this stock can only be sold to FHLB or other member banks at par value per share.

***Federal Funds Sold and Other Overnight Interest-Bearing Deposits***

The carrying amounts of short-term federal funds sold and securities purchased under agreements to resell, interest earning deposits with banks, and cash and due from banks approximate fair value. Federal funds sold and securities purchased under agreements to resell classified as short-term generally mature in 90 days or less.

***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.

***Cash Surrender Value Life Insurance***

The fair value of Bank owned life insurance (BOLI) approximates the carrying amount. Upon liquidation of these investments, the Company would receive the cash surrender value which equals the carrying amount.

***Accrued Interest Receivable and Payable***

For accrued interest receivable and payable, the carrying amount is a reasonable estimate of fair value because of the short maturity for these financial instruments.

***Deposits***

The fair value of deposits with no stated maturity, such as noninterest-bearing demand, NOW accounts, savings, and money market, is equal to the amount payable on demand. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

***Securities Sold under Agreements to Repurchase and Interest-bearing Demand Notes to U.S. Treasury***

For securities sold under agreements to repurchase and interest-bearing demand notes to U.S. Treasury, the carrying amount is a reasonable estimate of fair value, as such instruments reprice in a short time period.

***Subordinated Notes and Other Borrowings***

The fair value of subordinated notes and other borrowings is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for other borrowed money of similar remaining maturities.



**HAWTHORN BANCSHARES, INC.****AND SUBSIDIARIES**

## Notes to the Consolidated Financial Statements

*(Unaudited)*

A summary of the carrying amounts and fair values of the Company's financial instruments at March 31, 2013 and December 31, 2012 is as follows:

	March 31, 2013 Fair Value Measurements				
	March 31, 2013		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Net Significant Unobservable Inputs (Level 3)
<i>(in thousands)</i>	Carrying amount	Fair value			
<b>Financial Assets:</b>					
Cash and due from banks	\$ 19,258	\$ 19,258	\$ 19,258	\$ 0	\$ 0
Federal fund sold and overnight interest-bearing deposits	24,604	24,604	24,604	0	0
Investment in available-for-sale securities	231,991	231,991	2,023	229,968	0
Loans, net	819,711	821,352	0	0	821,352
Investment in FHLB stock	2,276	2,276	0	2,276	0
Mortgage servicing rights	2,689	2,689	0	0	2,689
Cash surrender value - life insurance	2,157	2,157	0	2,157	0
Accrued interest receivable	5,023	5,023	5,023	0	0
	\$ 1,107,709	\$ 1,109,350	\$ 50,908	\$ 234,401	\$ 824,041
<b>Financial Liabilities:</b>					
Deposits:					
Non-interest bearing demand	\$ 177,405	\$ 177,405	\$ 177,405	\$ 0	\$ 0
Savings, interest checking and money market	439,644	439,644	439,644	0	0
Time deposits	382,831	386,836	0	0	386,836
Federal funds purchased and securities sold under agreements to repurchase	17,539	17,539	17,539	0	0
Subordinated notes	49,486	31,404	0	31,404	0
Federal Home Loan Bank advances	20,071	20,537	0	20,537	0
Accrued interest payable	1,102	1,102	1,102	0	0
	\$ 1,088,078	\$ 1,074,467	\$ 635,690	\$ 51,941	\$ 386,836

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

	December 31, 2012 Fair Value Measurements				
	December 31, 2012		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Net Significant Unobservable Inputs (Level 3)
	Carrying amount	Fair value			
<i>(in thousands)</i>					
<b>Financial Assets:</b>					
Cash and due from banks	\$ 31,020	\$ 31,020	\$ 31,020	\$ 0	\$ 0
Federal fund sold and overnight interest-bearing deposits	27,857	27,857	27,857	0	0
Investment in available-for-sale securities	200,246	200,246	2,030	198,216	0
Loans, net	832,142	834,824	0	0	834,824
Investment in FHLB stock	2,278	2,278	0	2,278	0
Mortgage servicing rights	2,549	2,549	0	0	2,549
Cash surrender value life insurance	2,136	2,136	0	2,136	0
Accrued interest receivable	5,190	5,190	5,190	0	0
	\$ 1,103,418	\$ 1,106,100	\$ 66,097	\$ 202,630	\$ 837,373
<b>Financial Liabilities:</b>					
Deposits:					
Non-interest bearing demand	\$ 192,271	\$ 192,271	\$ 192,271	\$ 0	\$ 0
Savings, interest checking, and money market	405,702	405,702	405,702	0	0
Time deposits	393,302	397,986	0	0	397,986
Federal funds purchased and securities sold under agreements to repurchase	21,058	21,058	21,058	0	0
Subordinated notes	49,486	13,154	0	13,154	0
Federal Home Loan Bank advances	20,126	20,651	0	20,651	0
Accrued interest payable	909	909	909	0	0
	\$ 1,082,854	\$ 1,051,731	\$ 619,940	\$ 33,805	\$ 397,986

**Off-Balance Sheet Financial Instruments**

The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the likelihood of the counterparties drawing on such financial instruments, and the present creditworthiness of such counterparties. The Company believes such commitments have been made on terms that are competitive in the markets in which it operates.

**Limitations**

The fair value estimates provided are made at a point in time based on market information and information about the financial instruments. Because no market exists for a portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the fair value estimates.



**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

**(14) Pending Litigation**

The Company and its subsidiaries are defendants in various legal actions incidental to the Company's past and current business activities. Based on the Company's analysis, and considering the inherent uncertainties associated with litigation, management does not believe that it is reasonably possible that these legal actions will materially adversely affect the Company's consolidated financial condition or results of operations in the near term.

On November 18, 2010, a suit was filed against the Company and its subsidiary, the Bank, in the Circuit Court of Jackson County for the Eastern Division of Missouri state court by a customer alleging that the fees associated with the Bank's automated overdraft program in connection with its debit card and ATM cards constitute unlawful interest in violation of Missouri's usury laws. The suit seeks class-action status for Bank customers who have paid overdraft fees on their checking accounts. The suit seeks forfeiture and refund of twice the amount of improper overdraft fees assessed and collected. The court has denied the Bank's motion to dismiss the suit. At this stage of the litigation, it is not possible for management of the Bank to determine the probability of a material adverse outcome or reasonably estimate the amount of any potential loss.

On December 17, 2009, a suit was filed against the Bank in Circuit Court of Jackson County for the Eastern Division of Missouri state court by a customer alleging that the Bank had not followed through on its commitment to fund a loan request. A jury found in favor of the customer and awarded \$630,000 in damages to the plaintiffs, including \$200,000 in punitive damages. The jury verdict was upheld at the appellate level. At December 31, 2012, the Company's consolidated balance sheets included reserves for payment of the jury award as the Company is awaiting the Court's determination as to the order in which proceeds will be applied. After insurance proceeds, the Company's net loss for these jury awards is expected to be approximately \$275,000.

**Item 2 Management's Discussion and Analysis of Financial Condition**

**And Results of Operations**

**Forward-Looking Statements**

This report contains certain forward-looking statements with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company and its subsidiaries, including, without limitation:

statements that are not historical in nature, and

statements preceded by, followed by or that include the words *believes, expects, may, will, should, could, anticipates, estimates, intends* or similar expressions.

Forward-looking statements are not guarantees of future performance or results. They involve risks, uncertainties and assumptions. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

competitive pressures among financial services companies may increase significantly,

changes in the interest rate environment may reduce interest margins,

general economic conditions, either nationally or in Missouri, may be less favorable than expected and may adversely affect the quality of our loans and other assets,

increases in non-performing assets in the loan portfolios and adverse economic conditions may necessitate increases to our provisions for loan losses,

costs or difficulties related to the integration of the business of the Company and its acquisition targets may be greater than expected,

legislative or regulatory changes may adversely affect the business in which the Company and its subsidiaries are engaged, and

changes may occur in the securities markets.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, or the Dodd-Frank Act, was enacted on July 21, 2010. Provisions of the Act address many issues including, but not limited to, capital, interchange fees, compliance and risk management, debit card overdraft fees, the establishment of a new consumer regulator, healthcare, incentive compensation, expanded disclosures and corporate governance. While many of the new regulations under the Act are expected to primarily impact financial institutions with assets greater than \$10 billion, the Company expects these new regulations could reduce revenues and increase expenses in the future. Management is currently assessing the impact of the Act and of the regulations anticipated to be promulgated under the Act.

The Company has described under the caption *Risk Factors* in the Annual Report on Form 10-K for the year ended December 31, 2012 and in other reports that the company files with the SEC from time to time, additional factors that could cause actual results to be materially different from those described in the forward-looking statements. Other factors that have not been identified in this report could also have this effect. You are cautioned not to put undue reliance on any forward-looking statement, which speak only as of the date they were made.

**Overview**

## Edgar Filing: HAWTHORN BANCSHARES, INC. - Form 10-Q

Through the branch network of its subsidiary bank, the Company provides a broad range of commercial and personal banking services, including certificates of deposit, individual retirement and other time deposit accounts, checking and other demand deposit accounts, interest checking accounts, savings accounts, and money market accounts. The Company also provides a wide range of lending services, including real estate, commercial, installment, and other consumer loans. Other financial services that the Company provides include automated teller machines, trust services, credit-related insurance, and safe-deposit boxes. The geographic areas in which the Company provides products and services include the communities in and surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee's Summit, Missouri.



The Company's primary source of revenue is net interest income derived primarily from lending and deposit taking activities. A secondary source of revenue is investment income. The Company also derives income from trust, brokerage, credit card and mortgage banking activities and service charge income.

Much of the Company's business is commercial, commercial real estate development, and mortgage lending. The Company has experienced soft loan demand in the communities within which we operate during the current economic slowdown. The Company's income from mortgage brokerage activities is directly dependent on mortgage rates and the level of home purchases and refinancings.

The success of the Company's growth strategy depends primarily on the ability of the banking subsidiary to generate an increasing level of loans and deposits at acceptable risk levels and on acceptable terms without significant increases in non-interest expenses relative to revenues generated. The Company's financial performance also depends, in part, on the ability to manage various portfolios and to successfully introduce additional financial products and services by expanding new and existing customer relationships, utilizing improved technology, and enhancing customer satisfaction. Furthermore, the success of the Company's growth strategy depends on the ability to maintain sufficient regulatory capital levels during periods in which general economic conditions are unfavorable and despite economic conditions being beyond its control.

Hawthorn Bank (the Bank), the Company's subsidiary bank, is a full-service bank conducting a general banking business, offering its customers checking and savings accounts, debit cards, certificates of deposit, safety deposit boxes and a wide range of lending services, including commercial and industrial loans, residential real estate loans, single payment personal loans, installment loans and credit card accounts. In addition, the Bank provides trust services.

The deposit accounts of the Bank are insured by the Federal Deposit Insurance Corporation (FDIC) to the extent provided by law. The operations of the Bank are supervised and regulated by the FDIC and the Missouri Division of Finance. Periodic examinations of the Bank are conducted by representatives of the FDIC and the Missouri Division of Finance. Such regulations, supervision and examinations are principally for the benefit of depositors, rather than for the benefit of shareholders. The Company is subject to supervision and examination by the Federal Reserve Board.

## **CRITICAL ACCOUNTING POLICIES**

The following accounting policies are considered most critical to the understanding of the Company's financial condition and results of operations. These critical accounting policies require management's most difficult, subjective and complex judgments about matters that are inherently uncertain. Because these estimates and judgments are based on current circumstances, they may change over time or prove to be inaccurate based on actual experiences. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of a materially different financial condition and/or results of operations could reasonably be expected. The impact and any associated risks related to the critical accounting policies on the business operations are discussed throughout *Management's Discussion and Analysis of Financial Condition and Results of Operations*, where such policies affect the reported and expected financial results.

### ***Allowance for Loan Losses***

Management has identified the accounting policy related to the allowance for loan losses as critical to the understanding of the Company's results of operations, since the application of this policy requires significant management assumptions and estimates that could result in materially different amounts to be reported if conditions or underlying circumstances were to change. Further discussion of the methodology used in establishing the allowance and the impact of any associated risks related to these policies on the business operations is provided in Note 1 to the Company's consolidated financial statements and is also discussed in the *Lending and Credit Management* section below. Many of the loans are deemed collateral dependent for purposes of the measurement of the impairment loss, thus the fair value of the underlying collateral and sensitivity of such fair values due to changing market conditions, supply and demand, condition of the collateral and other factors can be volatile over periods of time. Such volatility can have an impact on the financial performance of the Company.

***Income Taxes***

Income taxes are accounted for under the asset / liability method by recognizing the amount of taxes payable or refundable for the current period and deferred tax assets and liabilities for future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Judgment is required in addressing the Company's future tax consequences of events that have been recognized in the consolidated financial statements or tax returns such as realization of the effects of temporary differences, net operating loss carry forwards and changes in tax laws or interpretations thereof. A valuation allowance is established when in the judgment of management, it is more likely than not that such deferred tax assets will not become realizable. In this case, the Company would adjust the recorded value of the deferred tax asset, which would result in a direct charge to income tax expense in the period that the determination was made. Likewise, the Company would reverse the valuation allowance when it is expected to realize the deferred tax asset. In addition, the Company is subject to the continuous examination of its tax returns by the Internal Revenue Service and other taxing authorities. The Company accrues for penalties and interest related to income taxes in income tax expense. As of March 31, 2013, the Company has not recognized any tax liabilities or any interest or penalties in income tax expense related to uncertain tax positions.

***Other Real Estate Owned and Repossessed Assets***

Other real estate owned and repossessed assets consist of loan collateral that has been repossessed through foreclosure. This collateral comprises commercial and residential real estate and other non-real estate property, including autos, manufactured homes, and construction equipment. Other real estate owned assets are initially recorded as held for sale at the fair value of the collateral less estimated selling costs. Any adjustment is recorded as a charge-off against the allowance for loan losses. The Company relies on external appraisals and assessment of property values by internal staff. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgment based on experience and expertise of internal specialists. Subsequent to foreclosure, valuations are updated periodically, and the assets may be written down to reflect a new cost basis. The write-downs are recorded as other real estate expense. The Company establishes a valuation allowance related to other real estate owned on an asset-by-asset basis. The valuation allowance is created during the holding period when the fair value less cost to sell is lower than the cost of the property.

**SELECTED CONSOLIDATED FINANCIAL DATA**

The following table presents selected consolidated financial information for the Company as of and for each of the three months ended March 31, 2013 and 2012, respectively. The selected consolidated financial data should be read in conjunction with the consolidated financial statements of the Company, including the accompanying notes, presented elsewhere herein.

**Selected Financial Data**

(In thousands, except per share data)	<b>Three Months Ended</b>	
	<b>2013</b>	<b>March 31, 2012</b>
<b><u>Per Share Data</u></b>		
Basic (loss) earnings per common share	\$ (0.09)	\$ 0.20
Diluted (loss) earnings per common share	(0.09)	0.20
Dividends paid on preferred stock	228	378
Accretion of discount on preferred stock	72	119
Dividends paid on common stock	242	233
Book value per common share	15.29	15.37
Market price per common share	11.52	7.22
<b><u>Selected Ratios</u></b>		
<i>(Based on average balance sheets)</i>		
Return on average total assets	(0.05)%	0.49%
Return on average common stockholders' equity	(2.33)%	5.21%
Average common stockholders' equity to average total assets	7.85%	8.68%
<i>(Based on end-of-period data)</i>		
Efficiency ratio(1)	93.70%	74.15%
Period-end common stockholders' equity to period-end assets	7.66%	8.61%
Period-end stockholders' equity to period-end assets	6.14%	6.17%
Total risk-based capital ratio	16.84%	18.28%
Tier 1 risk-based capital ratio	13.55%	15.45%
Leverage ratio	10.09%	11.43%

(1) Efficiency ratio is calculated as non-interest expense as a percent of revenue. Total revenue includes net interest and non-interest income.

**RESULTS OF OPERATIONS ANALYSIS**

The Company has prepared all of the consolidated financial information in this report in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). In preparing the consolidated financial statements in accordance with U.S. GAAP, the Company makes estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurances that actual results will not differ from those estimates.

<i>(In thousands)</i>	<b>Three Months Ended March 31,</b>			
	<b>2013</b>	<b>2012</b>	<b>\$ Change</b>	<b>% Change</b>
Net interest income	\$ 9,729	\$ 10,815	\$ (1,086)	(10.0)%
Provision for loan losses	1,000	1,700	(700)	(41.2)
Noninterest income	2,713			