# UNITED STATES SECURITIES AND EXCHANGE COMMISSION <br> Washington, D.C. 20549 <br> FORM 10-Q 

(Mark One)
b Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarterly period ended June 30, 2010
or
o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the transition period from $\qquad$ to $\qquad$
Commission File Number: 0-23636
HAWTHORN BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

## Missouri

(State or other jurisdiction of of incorporation or organization)

43-1626350
(I.R.S. Employer

Identification No.)

# 300 Southwest Longview Boulevard, Lee s Summit, Missouri 64081 <br> (Address of principal executive offices) (Zip Code) 

(816) 347-8100
(Registrant $s$ telephone number, including area code)
N/A
(Former name, former address and former fiscal year, if changed since last report.)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. $\mathbf{p}$ Yes o No Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T ( $\$ 232.405$ of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). o Yes o No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.:

Large accelerated filer o Accelerated filer o Non-accelerated filer p Smaller reporting company o

> (Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). $\mathbf{o}$ Yes $p$ No
As of August 13, 2010 the registrant had 4,474,033 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)

|  | $\begin{gathered} \text { June 30, } \\ 2010 \end{gathered}$ | $\begin{gathered} \text { December 31, } \\ 2009 \end{gathered}$ |
| :---: | :---: | :---: |
| ASSETS |  |  |
| Loans | \$ 944,652,333 | \$ 991,614,007 |
| Allowances for loan losses | $(12,231,596)$ | (14,796,549) |
| Net loans | 932,420,737 | 976,817,458 |
| Investment in available-for-sale securities, at fair value | 167,970,334 | 152,926,685 |
| Federal funds sold and securities purchased under agreements to resell | 178,202 | 89,752 |
| Cash and due from banks | 55,849,897 | 24,575,943 |
| Premises and equipment net | 37,634,200 | 38,623,293 |
| Other real estate owned and repossessed assets | 14,203,849 | 8,490,914 |
| Accrued interest receivable | 5,933,185 | 6,625,557 |
| Mortgage servicing rights | 2,005,639 | 2,020,964 |
| Intangible assets net | 1,213,561 | 1,503,986 |
| Cash surrender value life insurance | 1,960,066 | 1,929,910 |
| Other assets | 20,173,664 | 22,866,092 |
| Total assets | \$ 1,239,543,334 | \$ 1,236, 470,554 |
| LIABILITIES AND STOCKHOLDERS EQUITY |  |  |
| Deposits: |  |  |
| Non-interest bearing demand | \$ 131,505,268 | \$ 135,017,639 |
| Savings, interest checking and money market | 392,324,418 | 354,284,004 |
| Time deposits \$ 100,000 and over | 129,039,802 | 137,860,435 |
| Other time deposits | 318,488,783 | 329,160,719 |
| Total deposits | 971,358,271 | 956,322,797 |
| Federal funds purchased and securities sold under agreements to repurchase | 35,168,837 | 36,645,434 |
| Subordinated notes | 49,486,000 | 49,486,000 |
| Other borrowed money | 67,349,774 | 79,317,302 |
| Accrued interest payable | 2,296,948 | 2,438,121 |
| Other liabilities | 5,062,882 | 4,489,617 |
| Total liabilities | 1,130,722,712 | 1,128,699,271 |
| Stockholders equity: |  |  |
| Preferred stock, \$1,000 par value Authorized and issued 30,255 shares | 28,603,005 | 28,364,768 |
|  | 4,463,813 | 4,463,813 |


| Common stock, \$1 par value Authorized $15,000,000$ shares; issued |  |  |
| :--- | ---: | ---: |
| $4,635,891$ and 4,463,813 shares, respectively | $29,061,855$ | $26,970,745$ |
| Surplus | $48,127,292$ | $50,576,551$ |
| Retained earnings | $2,081,475$ | 912,224 |
| Accumulated other comprehensive income, net of tax | $(3,516,818)$ | $(3,516,818)$ |
| Treasury stock; 161,858 shares, at cost | $108,820,622$ | $107,771,283$ |
| Total stockholders equity |  |  |
| Total liabilities and stockholders equity | $\$ 1,239,543,334$ | $\$ 1,236,470,554$ |

See accompanying notes to consolidated financial statements.

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

|  | For the Three Months <br> Ended <br> June 30, |  | For the Six Months Ended June 30, |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2010 | 2009 | 2010 | 2009 |
| INTEREST INCOME |  |  |  |  |
| Interest and fees on loans | \$ 13,633,597 | \$ 14,547,559 | \$ 27,052,073 | \$ 28,991,585 |
| Interest on debt securities: |  |  |  |  |
| Taxable | 1,118,098 | 1,114,711 | 2,182,077 | 2,277,218 |
| Nontaxable | 294,553 | 344,106 | 620,755 | 737,722 |
| Interest on federal funds sold and securities purchased under agreements to resell | 47 | 43 | 83 | 193 |
| Interest on interest-bearing deposits | 21,891 | 17,617 | 35,522 | 32,009 |
| Dividends on other securities | 34,750 | 36,709 | 85,447 | 56,268 |
| Total interest income | 15,102,936 | 16,060,745 | 29,975,957 | 32,094,995 |
| INTEREST EXPENSE |  |  |  |  |
| Interest on deposits: |  |  |  |  |
| Savings, interest checking and money market | 554,453 | 746,897 | 1,185,206 | 1,696,847 |
| Time deposit accounts \$100,000 and over | 651,252 | 1,027,274 | 1,362,634 | 2,107,520 |
| Other time deposit accounts | 1,850,082 | 2,839,268 | 3,848,733 | 5,779,149 |
| Interest on federal funds purchased and securities sold under agreements to |  |  |  |  |
|  | 19,123 | 18,083 | 39,663 | 40,570 |
| Interest on subordinated notes | 323,246 | 628,057 | 847,546 | 1,290,103 |
| Interest on other borrowed money | 590,653 | 783,763 | 1,267,014 | 1,632,946 |
| Total interest expense | 3,988,809 | 6,043,342 | 8,550,796 | 12,547,135 |
| Net interest income | 11,114,127 | 10,017,403 | 21,425,161 | 19,547,860 |
| Provision for loan losses | 2,150,000 | 1,404,000 | 4,655,000 | 3,154,000 |
| Net interest income after provision for loan |  |  |  |  |
| losses | 8,964,127 | 8,613,403 | 16,770,161 | 16,393,860 |
| NON-INTEREST INCOME |  |  |  |  |
| Service charges on deposit accounts | 1,427,202 | 1,455,411 | 2,723,290 | 2,833,210 |
| Trust department income | 200,644 | 183,672 | 379,506 | 385,319 |
| Gain on sale of mortgage loans, net | 297,201 | 927,129 | 521,774 | 1,948,100 |
| Other | 524,973 | 241,278 | 830,906 | 405,629 |
| Total non-interest income | 2,450,020 | 2,807,490 | 4,455,476 | 5,572,258 |
| NON-INTEREST EXPENSE |  |  |  |  |
| Salaries and employee benefits | 4,550,320 | 4,587,388 | 9,207,441 | 8,949,670 |

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| Occupancy expense, net |  | 604,734 |  | 555,158 |  | 1,226,406 |  | 1,163,435 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Furniture and equipment expense |  | 534,611 |  | 724,273 |  | 1,026,650 |  | 1,287,931 |
| FDIC insurance assessment |  | 435,020 |  | 983,001 |  | 845,198 |  | 1,663,782 |
| Legal, examination, and professional fees |  | 336,033 |  | 312,624 |  | 583,323 |  | 673,494 |
| Advertising and promotion |  | 296,834 |  | 318,447 |  | 575,023 |  | 599,718 |
| Postage, printing, and supplies |  | 286,190 |  | 277,942 |  | 574,356 |  | 562,412 |
| Processing expense |  | 856,495 |  | 838,031 |  | 1,706,860 |  | 1,692,779 |
| Other real estate expense |  | 1,506,291 |  | 170,944 |  | 2,012,746 |  | 335,261 |
| Other |  | 913,110 |  | 893,669 |  | 1,692,381 |  | 1,727,727 |
| Total non-interest expense |  | 10,319,638 |  | 9,661,477 |  | 19,450,384 |  | 18,656,209 |
| Income before income taxes |  | 1,094,509 |  | 1,759,416 |  | 1,775,253 |  | 3,309,909 |
| Less income taxes |  | 312,043 |  | 555,128 |  | 499,019 |  | 1,048,990 |
| Net income |  | 782,466 |  | 1,204,288 |  | 1,276,234 |  | 2,260,919 |
| Preferred stock dividends |  | 382,390 |  | 382,389 |  | 752,173 |  | 756,375 |
| Accretion of discount on preferred stock |  | 119,118 |  | 119,119 |  | 238,237 |  | 238,237 |
| Net income available to common shareholders | \$ | 280,958 | \$ | 702,780 | \$ | 285,824 | \$ | 1,266,307 |
| Basic earnings per share | \$ | 0.06 | \$ | 0.16 | \$ | 0.06 | \$ | 0.28 |
| Diluted earnings per share | \$ | 0.06 | \$ | 0.16 | \$ | 0.06 | \$ | 0.28 |

See accompanying notes to consolidated financial statements.

## HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Stockholders Equity (Unaudited)

| Preferred | Common |  | Accumulatedother |  |  | Total Stock holders |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | Retained | Comprehe | reasury |  |
|  |  |  |  | Incom |  |  |
| Stock | Stock | Surplus | Earnings | (Loss) | Stock | Equity |

## Balance, December 31, 2009

\$28,364,768 \$4,463,813 \$26,970,745 \$ 50,576,551 \$ 912,224 \$(3,516,818) \$ 107,771,283
Net income
1,276,234
1,276,234
Change in unrealized gain (loss) on securities:
Unrealized gain on debt and equity securities available-for-sale, net of tax Defined benefit pension plans: Amortization of prior service cost included in net periodic pension cost, net of tax

1,145,269
1,145,269

Total other comprehensive income $1,169,251$

Total
comprehensive
income
Stock based compensation expense 48,542 48,542
Accretion of preferred stock
discount
238,237
$(238,237)$
Stock dividend
Cash dividends declared, preferred stock

Cash dividends declared, common stock
$(688,313)$
$(688,313)$
Balance, June 30, 2010
\$28,603,005 \$ 4,463,813 \$ 29,061,855 \$ 48,127,292 \$2,081,475 \$ (3,516,818) \$ 108,820,622

Balance,
December 31, 2008

Net income
\$27,888,294 \$4,298,353 \$25,144,323 \$ 51,598,678 \$ 1,005,553 \$(3,516,818) \$ 106,418,383
2,260,919
2,260,919
Change in unrealized gain (loss) on securities:
Unrealized loss on debt and equity securities available-for-sale, net of tax
Defined benefit pension plans: Amortization of prior service cost included in net periodic pension cost, net of tax

Total other comprehensive loss

Total
comprehensive income

Stock based compensation expense 68,537
Accretion of preferred stock discount 238,236
$(238,236)$
Stock dividend
Cash dividends declared, preferred stock $(1,323,679)$
Cash dividends
declared, common
stock

Balance, June 30, 2009

See accompanying notes to consolidated financial statements.

## HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows (Unaudited)

## Cash flows from operating activities:

Net income
Adjustments to reconcile net income to net cash provided by operating activities:
Provision for loan losses
Depreciation expense
Net amortization of debt securities, premiums, and discounts
Amortization of intangible assets
Stock based compensation expense
Loss on sales and dispositions of premises and equipment
Other real estate owned impairment charges
Decrease (increase) in deferred tax asset, net
Decrease in accrued interest receivable
Increase in cash surrender value -life insurance
Decrease in other assets
(Decrease) increase in accrued interest payable
Increase in other liabilities
Origination of mortgage loans held for sale
Proceeds from the sale of mortgage loans held for sale
Gain on sale of mortgage loans, net
Other, net

## Net cash provided by operating activities

## Cash flows from investing activities:

Net decrease (increase) in loans
27,991,681
$(140,268,118)$
$(4,323,339)$
Purchase of available-for-sale debt securities
Proceeds from maturities of available-for-sale debt securities
Proceeds from calls of available-for-sale debt securities
Proceeds from sales of FHLB stock
Purchases of premises and equipment
Proceeds from sales of premises and equipment
Proceeds from sales of other real estate owned and repossessions
Net cash provided (used) by investing activities
98,037,862
$(71,446,366)$
28,780,100
54,907,262
595,200
$(239,112)$
$(365,831)$
34,528
574,815
4,802,109
1,514,552

19,734,250
$(6,008,907)$

## Cash flows from financing activities:

Net (decrease) increase in non-interest-bearing demand deposits
Net increase in savings, interest checking, and money market accounts
Net (decrease) increase in time deposits
Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase
Repayment of other borrowed money
(1,476,597)
4,063,197
(3,512,371)
4,569,698
38,040,414
6,030,766
$(19,492,569)$
18,246,802
(11,967,528)

| Cash dividends paid preferred stock |  | $(756,375)$ |  | $(613,504)$ |
| :---: | :---: | :---: | :---: | :---: |
| Cash dividends paid common stock |  | $(946,430)$ |  | $(1,737,329)$ |
| Net cash used by financing activities |  | $(111,456)$ |  | $(26,828,175)$ |
| Net increase (decrease) in cash and cash equivalents |  | 31,362,404 |  | $(22,191,309)$ |
| Cash and cash equivalents, beginning of year |  | 24,665,695 |  | 53,827,468 |
| Cash and cash equivalents, end of period | \$ | 56,028,099 | \$ | 31,636,159 |
| Supplemental disclosures of cash flow information: |  |  |  |  |
| Cash paid during the year for: |  |  |  |  |
| Interest | \$ | 8,691,969 | \$ | 12,091,018 |
| Income taxes |  | 200,000 |  |  |
| Supplemental schedule of noncash investing and financing activities: |  |  |  |  |
| Other real estate and repossessions acquired in settlement of loans | \$ | 11,750,040 | \$ | 1,222,578 |
| Dividends declared common stock |  | 215,098 |  | 455,014 |
| Stock dividend declared |  | 2,042,568 |  | 1,861,423 |

See accompanying notes to consolidated financial statements.

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## HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES <br> NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## Basis of Presentation

The accompanying unaudited condensed 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, and fair values of investments securities available-for-sale 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. Operating results for the three and six-month periods ended June 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. Our Company s management has evaluated and did not identify any subsequent events or transactions requiring recognition or disclosure in the consolidated financial statements.

These unaudited condensed consolidated interim financial statements should be read in conjunction with our Company s audited consolidated financial statements included in its 2009 Annual Report to Shareholders under the caption Consolidated Financial Statements and incorporated by reference into its Annual Report on Form 10-K for the year ended December 31, 2009 as Exhibit 13.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed and omitted. These financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly our Company s consolidated financial position as of June 30, 2010 and the consolidated statements of operations and cash flows for the three and six-month periods ended June 30, 2010 and 2009.

On July 1, 2010, our Company paid a special stock dividend of four percent to common shareholders of record at the close of business on May 19, 2010. For all periods presented, share information, including basic and diluted earnings per share, have been adjusted retroactively to reflect this change.
Loans and Allowance for Loan Losses
Major classifications in our Company s loan portfolio at June 30, 2010 and December 31, 2009 are as follows:

|  | June 30, | December 31, <br> $\mathbf{2 0 1 0}$ |
| :--- | ---: | ---: |
| Commercial, financial, and agricultural |  |  |
| Real estate construction residential | $\$ 140,226,749$ | $\$ 151,399,300$ |
| Real estate construction commercial | $37,709,566$ | $38,840,664$ |
| Real estate mortgage residential | $76,867,712$ | $77,936,569$ |
| Real estate mortgage commercial | $221,225,906$ | $232,332,124$ |
| Installment loans to individuals | $433,733,196$ | $453,975,271$ |
| Unamortized loan origination fees and costs, net | $34,700,584$ | $36,966,018$ |
|  | 188,620 | 164,061 |
| Total loans | $\$ 944,652,333$ | $\$ 991,614,007$ |

The Bank grants real estate, commercial, and installment 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 loans consist primarily of the financing of vehicles.

As shown in the above table, our Company s total loans have declined $\$ 46,962,000$, or $4.7 \%$, since December 31, 2009. Of this decline $\$ 7,567,000$ represents loans charged-off and $\$ 11,750,000$ represents loans that were foreclosed on and moved to Other Real Estate Owned and Repossessed Assets. Of the remaining \$27,645,000 decrease, $\$ 17,788,000$ represents payoffs/paydowns of nine large credits.
A summary of impaired loans as of June 30, 2010 and December 31, 2009 is as follows:

| June 30, 2010 | $\begin{gathered} \text { December 31, } \\ 2009 \end{gathered}$ |  |
| :---: | :---: | :---: |
| \$ 45,825,414 | \$ | 34,153,731 |
| 17,236,149 |  | 39,713,014 |
| \$ 63,061,563 | \$ | 73,866,745 |
| \$ 30,819,214 | \$ | 26,294,560 |
| 32,242,349 |  | 47,572,185 |
| \$ 63,061,563 | \$ | 73,866,745 |
| \$ 5,779,603 | \$ | 6,414,729 |
| 65,626,401 |  | 39,048,298 |
| 19,448,526 |  | 11,233,326 |

The table above shows our Company s investment in impaired loans at June 30, 2010 and December 31, 2009. These loans consist of loans on non-accrual status and other restructured loans whose terms have been modified and classified as troubled debt restructurings. Although our non-accrual loans significantly increased from $\$ 34,153,731$ at December 31, 2009 to $\$ 45,825,414$ at June 30, 2010, total impaired loans decreased $\$ 10,805,182$. The increase in nonaccrual loans did not impact total impaired loans or reserves for impaired loans as these loans were previously classified as impaired loans continuing to accrue interest, and adequately reserved for at December of 2009. The balance of impaired loans without reserves is $51 \%$ of total impaired loans at June 30, 2010 and $64 \%$ at December 31, 2009. Management believes the excess value in the collateral was sufficient at June 30, and December 31, and these loans did not require additional reserves.
The following is a summary of the allowance for loan losses for the three and six-months ended June 30, 2010:

## Balance at beginning of period

Additions:
Provision for loan losses

Total additions

Deductions:

Three Months Ended June
2010 30, 2009
\$ 14,657,622 \$ 13, 159,425

| $2,150,000$ | $1,404,000$ | $4,655,000$ | $3,154,000$ |
| :--- | :--- | :--- | :--- |
| $2,150,000$ | $1,404,000$ | $4,655,000$ | $3,154,000$ |

Six Months Ended June 30, 2010 2009
\$ 14,796,549 \$ 12,666,546

4,655,000
3,154,000

| Loans charged off | $4,760,386$ | 970,049 | $7,566,661$ | $2,351,407$ |
| :--- | :---: | ---: | ---: | ---: |
| Less recoveries on loans | $(184,360)$ | $(111,360)$ | $(346,708)$ | $(235,597)$ |
| Net loans charged off | $4,576,026$ | 858,689 | $7,219,953$ | $2,115,810$ |
| Balance at end of period | $\$ 12,231,596$ | $\$ 13,704,736$ | $\$ 12,231,596$ | $\$ 13,704,736$ |

## Investment Securities

A summary of investment securities by major category, at fair value, consisted of the following at June 30, 2010 and December 31, 2009.

|  | June 30, <br> $\mathbf{2 0 1 0}$ | December 31, <br> $\mathbf{2 0 0 9}$ |  |
| :--- | ---: | ---: | ---: |
| U.S. treasury | $\$ 1,027,266$ | $\$$ |  |
| Government sponsored enterprises | $51,856,056$ | $44,380,798$ |  |
| Asset-backed securities | $82,786,092$ | $69,434,650$ |  |
| Obligations of states and political subdivisions | $32,300,920$ | $39,111,237$ |  |
| Total available for sale securities | $\$ 167,970,334$ | $\$ 152,926,685$ |  |

The asset backed securities include agency mortgage-backed securities, which are guaranteed by government sponsored agencies such as the FHLMC, FNMA and GNMA. Our Company does not invest in subprime originated mortgage-backed or collateralized debt obligation instruments.

The amortized cost and fair value of securities classified as available-for-sale at June 30, 2010 and December 31, 2009 are as follows:

June 30, 2010
U.S. treasury

Government sponsored enterprises
Asset-backed securities
Obligations of states and political subdivisions

Total available for sale securities

| Amortized cost | $\begin{gathered} \text { Gross } \\ \text { unrealized } \\ \text { gains } \end{gathered}$ | Gross unrealized losses | Fair value |
| :---: | :---: | :---: | :---: |
| \$ 999,793 | \$ 27,473 | \$ | \$ 1,027,266 |
| 51,209,517 | 646,892 | 353 | 51,856,056 |
| 80,006,638 | 2,883,131 | 103,677 | 82,786,092 |
| 31,558,849 | 759,555 | 17,484 | 32,300,920 |
| \$ 163,774,797 | \$4,317,051 | \$ 121,514 | \$ 167,970,334 |

December 31, 2009
Government sponsored enterprises
Asset-backed securities
Obligations of states and political subdivisions

| $\$ 44,059,540$ | $\$ 371,258$ | $\$ 50,000$ | $\$ 44,380,798$ |  |
| ---: | ---: | ---: | ---: | ---: |
| $68,092,852$ | $1,585,774$ |  | 243,976 | $69,434,650$ |
| $38,456,246$ | 708,196 |  | 53,205 | $39,111,237$ |
|  |  |  |  |  |

Total available for sale securities
Restricted investments in equity securities, reported in other assets, in the amount of $\$ 6,158,350$ and $\$ 6,753,550$ as of June 30, 2010 and December 31, 2009, respectively, are recorded at cost, and consist primarily of Federal Home Loan Bank Stock and our Company s interest in the statutory trusts.

The amortized cost and fair value of debt securities classified as available-for-sale at June 30, 2010 and December 31, 2009, 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.

|  | Amortized <br> cost | Fair <br> value |
| :--- | ---: | ---: | ---: |
| Due in one year or less | $\$ 7,254,405$ | $\$ 7,342,844$ |
| Due after one year through five years | $57,985,369$ | $58,897,225$ |
| Due after five years through ten years | $14,900,448$ | $15,262,361$ |
| Due after ten years | $3,627,937$ | $3,681,812$ |
|  | $83,768,159$ | $85,184,242$ |
| Asset-backed securities | $80,006,638$ | $82,786,092$ |
| Total available for sale investment securities | $\$ 163,774,797$ | $\$ 167,970,334$ |

Debt securities with carrying values aggregating approximately $\$ 154,652,847$ and $\$ 132,322,000$ at June 30, 2010 and December 31, 2009, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

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 June 30, 2010 and December 31, 2009, were as follows:

$$
\text { Less than } 12 \text { months } 12 \text { months or more } \quad \text { Total }
$$

|  |  | Number |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | of |  |  |  |  |
| Fair | Unrealized | Fair | Unrealized Investment | Fair | Unrealized |  |
| Value | Losses | Value | Losses | Positions | Value | Losses |

At June 30, 2010
Government sponsored enterprises Asset-backed securities \$ 1,253,906 \$ (353) \$
\$
1 \$ 1,253,906 \$

Obligations of states and political subdivisions

$$
\begin{array}{ccccc}
1,060,656 & (13,725) & 236,241 & (3,759) \\
11,588,192 & \$(117,755) & \$ 236,241 & \$(3,759) \\
\text { Less than } \mathbf{1 2} \text { months } & \mathbf{1 2} \text { months or more }
\end{array}
$$

Unrealized Losses

## Number <br> of

| Fair | Unrealized | Fair | UnrealizedInvestment | Fair | Unrealized |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Value | Losses | Value | Losses | Positions | Value | Losses |

## At December 31, <br> 2009

Government
sponsored
enterprises
Asset-backed
securities
Obligations of states and political subdivisions

| $\$ 5,943,819$ | $\$(50,000)$ | $\$$ | $\$$ | 6 | $\$ 5,943,819$ | $(50,000)$ |  |
| ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| $14,600,160$ | $(243,904)$ | 20,551 |  | $(72)$ | 15 | $14,620,711$ | $\$(243,976)$ |
| $3,576,780$ | $(53,205)$ |  |  |  | 14 | $3,576,780$ | $(53,205)$ |
| $\$ 24,120,759$ | $\$(347,109)$ | $\$ 20,551$ | $\$$ | $(72)$ | 35 | $\$ 24,141,310$ | $\$(347,181)$ |

Our Company s available for sale portfolio consisted of approximately 299 securities at June 30, 2010, of which 17 securities were temporarily impaired. Two of these securities have been in the loss position for 12 months or longer. Our Company believes the $\$ 4,000$ in unrealized losses included in other comprehensive income at June 30, 2010 is attributable to changes in market interest rates and not the credit quality of the issuer and are not considered other-than-temporarily impaired. Our Company does not intend to sell these investments and it is not more likely than not that our Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity.

Our Company s available for sale portfolio consisted of approximately 305 securities at December 31, 2009. One of these securities had been in the loss position for 12 months or longer. The $\$ 72$ unrealized loss included in other comprehensive income at December 31, 2009 on this asset-backed security was caused by interest rate increases. Because the decline in fair value is attributable to changes in interest rates and not credit quality this investment was not considered other-than-temporarily impaired. As of June 30, 2010, this security was not in the unrealized loss position.

During the six months ended June 30, 2010 and June 30, 2009, there were no proceeds from sales of securities and no components of investment securities gains and losses which have been recognized in earnings.

## Intangible Assets

A summary of other intangible assets at June 30, 2010 and December 31, 2009 is as follows:

|  | Gross <br> Carrying <br> Amount | June 30, 2010 <br> Accumulated <br> Amortization | Net <br> Amount | Gross <br> Carrying <br> Amount | December 31, 2009 <br> Accumulated <br> Amortization | Net <br> Amount |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Amortizable |  |  |  |  |  |  |  |
| intangible assets: <br> Core deposit <br> intangible | $\$ 7,060,224$ | $\$(5,846,663)$ | $\$ 1,213,561$ | $\$ 7,060,224$ | $\$(5,556,238)$ | $\$ 1,503,986$ |  |
| Mortgage servicing <br> rights | $2,786,755$ | $(781,116)$ | $2,005,639$ | $2,945,019$ | $(924,055)$ | $2,020,964$ |  |
| Total amortizable <br> intangible assets | $\$ 9,846,979$ | $\$(6,627,779)$ | $\$ 3,219,200$ | $\$ 10,005,243$ | $\$(6,480,293)$ | $\$ 3,524,950$ |  |

Changes in the net carrying amount of other intangible assets for the six months ended June 30, 2010 are as follows:

|  | Core Deposit <br> Intangible <br> Asset | Mortgage <br> Servicing |
| :--- | ---: | ---: | ---: | ---: |
| Rights |  |  |

Mortgage servicing rights (MSRs) are amortized over the shorter of 7 years or the life of the loan. They are periodically reviewed for impairment and if impairment is indicated, recorded at fair value. At June 30, 2010 and December 31, 2009, no temporary impairment was recognized. The fair value of MSRs is based on the present value of expected cash flows, as further discussed in Fair Value of Financial Instruments. Mortgage loans serviced for others totaled approximately $\$ 273,237,000$ and $\$ 269,475,000$ at June 30, 2010 and December 31, 2009, respectively. Included in other noninterest income were real estate servicing fees for the six months ended June 30, 2010 and 2009 of $\$ 397,000$ and $\$ 444,000$, respectively.

Our Company s amortization expense on intangible assets in any given period may be different from the estimated amounts depending upon the acquisition of intangible assets, changes in mortgage interest rates, prepayment rates and other market conditions. The following table shows the estimated future amortization expense based on existing asset balances and the interest rate environment as of June 30, 2010 and for the next five years:

## Core Deposit

$\left.\begin{array}{crrr}\text { Intangible } & & \begin{array}{c}\text { Mortgage } \\ \text { Servicing }\end{array} \\ \text { Rishts }\end{array}\right]$

The aggregate amortization expense of intangible assets subject to amortization for the three and six-month periods ended June 30, 2010 is as follows:

|  | Three Months Ended |  | Six Months Ended |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
|  | June 30, |  | June 30, <br>  <br> Aggregate amortization expense |  | $\mathbf{2 0 1 0}$ |

## Income Taxes

At June 30, 2010 and December 31, 2009, our Company had $\$ 562,000$ of gross unrecognized tax benefits that if recognized would affect the effective tax rate. Our Company believes that during 2010 it is reasonably possible that there would be a reduction of $\$ 222,000$ in gross unrecognized tax benefits as a result of the lapse of statute of limitations for the 2006 tax year. At June 30, 2010, total interest accrued on unrecognized tax benefits was approximately $\$ 113,000$. As of June 30, 2010, there were no federal or state income tax examinations in process.

Our Company recognizes deferred tax assets only to the extent that they are expected to be used to reduce amounts that have been paid or will be paid to tax authorities. Management believes, based on all positive and negative evidence, that the deferred tax asset at June 30, 2010 is more likely-than-not-to be realized, and accordingly, no valuation allowance has been recorded. Future facts and circumstances may require a valuation allowance. Charges to establish a valuation allowance could have a material adverse effect on our results of operations and financial position.

## Employee Benefit Plans

Employee benefits charged to operating expenses are summarized for the three and six-month periods ended June 30, 2010 in the table below.

|  | For the Three Months Ended June 30, |  |  |  | For the Six Months Ended June 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | 2010 |  | 2009 |  | 2010 |  | 2009 |
| Payroll taxes | \$ | 283,673 | \$ | 279,697 | \$ | 605,640 | \$ | 608,998 |
| Medical plans |  | 393,503 |  | 386,819 |  | 798,355 |  | 757,364 |
| 401k match |  | 73,776 |  | 69,127 |  | 153,788 |  | 146,857 |
| Pension plan |  | 216,298 |  | 229,001 |  | 432,597 |  | 458,000 |
| Profit-sharing |  |  |  | 67,175 |  | 72,470 |  | 134,350 |
| Other |  | 32,688 |  | 31,493 |  | 74,016 |  | 52,628 |
| Total employee benefits | \$ | 999,938 | \$ | 1,063,312 |  | ,136,866 |  | ,158,197 |

Our Company provides a noncontributory defined benefit pension plan for all full-time employees. Pension expense for the periods indicated is as follows:

|  | Estimated <br> $\mathbf{2 0 1 0}$ | Actual <br> $\mathbf{2 0 0 9}$ |
| :--- | :---: | :---: |
| Service cost benefits earned during the year |  | 844,178 |
| Interest cost on projected benefit obligations | 556,047 | 509,482 |
| Expected return on plan assets | $(613,659)$ | $(539,283)$ |


| Amortization of prior service cost <br> Amortization of net gains | 78,628 | 78,628 <br> $(9,075)$ |
| :--- | :---: | :---: |
| Net periodic pension expense Annual $\$ 865,194$ | $\$ 890,692$ |  |
| Pension expense three months ended June 30, (actual) | $\$ 216,298$ | $\$ 229,001$ |
| Pension expense six months ended June 30, (actual) | $\$ 432,597$ | $\$ 458,000$ |

Our Company made a $\$ 1,000,000$ contribution to the defined benefit plan in 2009, and the minimum required contribution for 2010 is estimated to be $\$ 864,000$. Our Company has contributed $\$ 366,000$ through July 2010.

## Stock-Based Compensation

Our Company s stock option plan provides for the grant of options to purchase up to 486,720 shares of our Company s common stock to officers and other key employees of our 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 10,294 options issued in 2008 that vested immediately.
The following table summarizes our Company s stock option activity:

|  | Options | Weighted <br> Average <br> Exercise <br> Price | Aggregate <br> Intrinsic <br> Value <br> (000) | Weighted <br> Average <br> Contractual <br> Term <br> (in years) |
| :--- | :---: | :---: | :---: | :---: |
| Outstanding at January 1, 2010* <br> Granted | 286,948 | $\$ 24.11$ |  |  |
| Exercised <br> Forfeited <br> Canceled |  |  |  |  |
| Outstanding at June 30, 2010 | 286,948 | $\$ 24.11$ | $\$$ | 4.4 |
| Exercisable at June 30, 2010 | 239,780 | $\$ 24.07$ | $\$$ | 3.9 |

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

2010. 

Total stock-based compensation expense for the three and six months ended June 30, 2010 and 2009 was $\$ 19,000$ and $\$ 48,000$, respectively, and $\$ 31,000$ and $\$ 68,000$, respectively. As of June 30, 2010, the total unrecognized compensation expense related to non-vested stock awards was $\$ 120,000$ and the related weighted average period over which it is expected to be recognized is approximately three years.

## Comprehensive Income

Comprehensive income for the three and six months ended June 30, 2010 and 2009 is summarized as follows:

Net income

| Three Months Ended June | Six Months Ended June |  |  |
| :---: | :---: | :---: | :---: | :---: |
| 30, | 30, |  |  |
| $\mathbf{2 0 1 0}$ | $\mathbf{2 0 0 9}$ | $\mathbf{2 0 1 0}$ | $\mathbf{2 0 0 9}$ |
| $\$ 782,466$ | $\$ 1,204,288$ | $\$ 1,276,234$ | $\$ 2,260,919$ |
|  |  |  |  |
| $1,049,068$ | $(150,276)$ | $1,145,269$ | $(249,861)$ |
|  |  |  |  |
| 11,991 | 12,045 | 23,982 | 24,090 |


| Total other comprehensive income (loss) | $1,061,059$ | $(138,231)$ | $1,169,251$ | $(225,771)$ |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Comprehensive income | $\$ 1,843,525$ | $\$ 1,066,057$ | $\$ 2,445,485$ | $\$ 2,035,148$ |

## Preferred Stock

On December 19, 2008, our 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. Our Company has used the funds received, as discussed below, to continue to provide loans to its customers and to look for ways to deploy additional funds to benefit the communities in our Company s market area.

Participation in this program included our 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 265,471 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. The allocated carrying values of the senior preferred stock and common stock warrants at June 30, 2010 were $\$ 28,603,000$ and $\$ 2,382,000$, respectively.

The preferred shares carry a $5 \%$ cumulative dividend for the first five years and $9 \%$ thereafter if not redeemed. The preferred shares are redeemable after three years at par plus accrued dividends, or before three years if our Company raises Tier 1 capital in an amount equal to the preferred stock issued. The preferred stock generally does not have any voting rights, subject to an exception in the event our Company fails to pay dividends on the preferred stock for six or more quarterly periods, whether or not consecutive. Under such circumstances, the Treasury will be entitled to vote to elect two directors to the board until all unpaid dividends have been paid or declared and set apart for payment. Our Company is prohibited from paying any dividends with respect to shares of common stock unless all accrued and unpaid dividends are paid in full on the senior preferred stock for all past dividend periods. The Treasury Department may also transfer the senior preferred stock to a third party at any time.

The common stock warrant is exercisable immediately with a ten year term, in whole or in part, at an exercise price of $\$ 17.10$ 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. Through the six months ended June 30, 2010, our Company had declared and paid dividends in the amount of $\$ 756,000$ on the preferred stock.

## 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 three and six months ending June 30, 2010. Diluted earnings per share gives effect to all dilutive potential common shares that were outstanding during the three and six months ending June $30,2010$.

The weighted average common and diluted shares outstanding and earnings per share amounts have been adjusted to give effect to the $4 \%$ stock dividend on July 1, 2010. The calculations of basic and diluted earnings per share are as follows:

Net income, basic and diluted
Less:
Preferred stock dividends
Accretion of discount on preferred stock
Net income available to common shareholders
Average shares outstanding
Average shares outstanding including dilutive stock options

Net income per share, basic Net income per share, diluted

For the Three Months

| Ended June 30, |  |  | For the Six Months Ended June 30, |  |
| :---: | :---: | :---: | :---: | :---: |
|  |  | 2009 | 2010 | 2009 |
| \$ | 782,466 | \$ 1,204,288 | \$ 1,276,234 | \$2,260,919 |
|  | 382,390 | 382,389 | 752,173 | 756,375 |
|  | 119,118 | 119,119 | 238,237 | 238,237 |
|  | 280,958 | 702,780 | 285,824 | 1,266,307 |
|  | 4,474,033 | 4,474,033 | 4,474,033 | 4,474,033 |
|  | 4,474,033 | \$ 4,474,033 | \$4,474,033 | \$4,474,033 |
| \$ | 0.06 | \$ 0.16 | \$ 0.06 | \$ 0.28 |
|  | 0.06 | 0.16 | 0.06 | 0.28 |

Under the treasury stock method, outstanding stock options are dilutive when the average market price of our Company s common stock, when combined with the effect of any unamortized compensation expense, exceeds the option price during the period, except when our 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.

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The following options and warrant to purchase shares during the three and six months ended 2010 and 2009 were not included in the respective computations of diluted earnings per share because the exercise price, 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 June 30, |  | Six months ended June 30 , |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | 2010 | 2009 | 2010 | 2009 |
| Anti-dilutive shares | option shares | 286,948 | 286,948 | 286,948 | 286,948 |
| Anti-dilutive shares | warrant shares | 265,471 | 265,471 | 265,471 | 265,471 |

## Fair Value Measurements

Our Company uses fair value measurements to record fair value adjustments to certain financial and nonfinancial assets and liabilities. The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, Fair Value Measurements and Disclosures, 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 June 30, 2010 and December 31, 2009 there were no transfers into or out of Level 2.
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 our 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 has significantly decreased and on identifying circumstances when a transaction may not be considered orderly.
Our 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.

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:

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

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

## Available-for-sale securities

Available-for-sale securities are recorded at fair value on a recurring basis. Available-for-sale securities is the only balance sheet category our Company is required, in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), to carry at fair value on a recurring basis. Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, our Company obtains fair value measurements from an independent pricing service. The fair value measurements consider 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.


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

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

## Impaired Loans

Our Company does not record loans at fair value on a recurring basis other than loans that are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with the FASB ASC Topic 310, Accounting by Creditors for Impairment of a Loan. Impaired loans for which an allowance is established are generally based on market prices for similar assets determined through independent appraisals, the fair
value of the collateral for a collateral-dependent loan, or in the case of trouble debt restructured loans, impairment is measured by discounting the total expected future cash flows. Because many of these inputs are not observable, the measurements are classified as Level 3. As of June 30, 2010, our Company identified $\$ 30.8$ million in impaired loans that had specific allowances for losses aggregating $\$ 5.8$ million. Related to these loans, there was $\$ 6.4$ million in charge-offs recorded during 2010. As of December 31, 2009, our Company identified $\$ 26.3$ million in impaired loans that had specific allowances for losses aggregating $\$ 6.4$ million. Related to these loans, there was $\$ 4.2$ million in charge-offs recorded during 2009.
Other Real Estate Owned and Repossessed Assets
Other real estate owned and repossessed assets consist of loan collateral which has been repossessed through foreclosure. This collateral is comprised 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 cost basis or fair value of the collateral less estimated selling costs. Our Company relies on external appraisals and assessment of property values by our 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.

## Description

## |l|||

Impaired loans:
Commercial
Construction
residential
Construction
Remmercial
Real estate
residential
Real estate
commercial
Total
Other real estate owned and
repossessed assets repossessed assets

Description
Impaired loans:
Commercial
Construction residential
Construction commercial
Real estate residential
Real estate commercial
\$ 727,504
2,342,161
13,878,815
4,497,015
3,594,116
\$ 25,039,611
\$ 14,203,849
\$ \$ 727,504 \$ (1,009,093)
Quoted
Prices
in
Active
Markets for

Other Significant
Six Months
Ended June 30, Identical Observable Unobservable 2010


2010
Assets
(Level
1)
2)

Inputs
(Level 3)
Total Gains (Losses)


Total

Other real estate owned and repossessed assets
\$ 19,879,831 \$
$\$ \quad 8,490,914 \quad \$ \quad \$ \quad \$ 8,490,914 \quad \$$

For both recurring and nonrecurring fair value measurements, there were no transfers between the various levels for the six months ending June 30, 2010 or the year ended December 31, 2009.
Fair Value of Financial Instruments
The carrying amounts and estimated fair values of financial instruments help by our Company, in addition to a discussion of the methods used and assumptions made in computing those estimates, are set forth below.

## Loans

The fair value of loans is estimated based on present values using applicable risk-adjusted spreads to the U. S. Treasury curve to approximate current interest rates applicable to each category of such financial instruments. The fair values of impaired loans are generally based on market prices for similar assets determined through independent appraisals or discounted values of independent appraisals and brokers opinions of value. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC Topic 820.
Investment 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 proved in the Fair Value Measurement section above. A schedule of investment securities by category and maturity is provided in the notes on Investment Securities.

## Federal Funds Sold, Cash, and Due from Banks

For federal funds sold, cash, and due from banks, the carrying amount is a reasonable estimate of fair value, as such instruments reprice in a short time period.

## Mortgage Servicing Rights

The fair value of mortgage servicing rights is calculated by pooling loans into buckets of loans having similar characteristics and performing a present value analysis of future cash flows utilizing the current market rate. The buckets are created based on individual loans characteristics such as loan age, note rate, product type, and the investor remittance schedule. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC Topic 820.

## 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.

## Other Borrowings

The fair value of other borrowings, which include subordinated notes and Federal Home Loan 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.

A summary of the carrying amounts and fair values of our Company s financial instruments at June 30, 2010 and December 31, 2009 is as follows:

## Assets:

Loans
Investment in debt securities
Federal fund sold and securities purchased under agreements to resell
Cash and due from banks
Mortgage servicing rights
Accrued interest receivable

```
\$ 932,420,737 167,970,334 167,970,334
\begin{tabular}{rr}
178,202 & 178,202 \\
\(55,849,897\) & \(55,849,897\) \\
\(2,005,639\) & \(2,888,000\) \\
\(5,933,185\) & \(5,933,185\)
\end{tabular}
```

\$ 1,164,357,994 \$ 1,172,132,618 \$ 1,163,056,359 \$ 1,171,426,937

## Liabilities:

Deposits:
Demand
NOW
Savings
Money market
Time
Federal funds purchased and securities sold under agreements to repurchase
Subordinated notes
Other borrowings
Accrued interest payable
\$ 131,505,268
131,505,268 \$ 131,505,268
173,056,049 52,399,604 166,868,765 447,528,585

| $35,168,837$ | $35,168,837$ | $36,645,434$ | $36,645,434$ |
| ---: | ---: | ---: | ---: |
| $49,486,000$ | $21,638,000$ | $49,486,000$ | $18,329,000$ |
| $67,349,774$ | $68,105,000$ | $79,317,302$ | $80,557,000$ |
| $2,296,948$ | $2,296,948$ | $2,438,121$ | $2,438,121$ |

$\$ 1,125,659,830 \quad \$ 1,108,072,471 \quad \$ 1,124,209,654 \quad \$ 1,105,282,198$

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## 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 our 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 our 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 our Company and its acquisition targets may be greater than expected,
legislative or regulatory changes may adversely affect the business in which our Company and its subsidiaries are engaged, including those discussed below in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 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 are for financial institutions with assets greater than $\$ 10$ billion, our Company expects the new regulations to reduce our revenues and increase our expenses in the future. Management is currently assessing the impact of this new regulation.

We have described under the caption Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2009 and in other reports that we file 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 we have not 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

Our Company, Hawthorn Bancshares, Inc., is a community-based, financial institution bank holding company headquartered in Lee s Summit, Missouri. Our Company was incorporated under the laws of the State of Missouri on October 23, 1992 as Exchange National Bancshares, Inc. and changed its name to Hawthorn Bancshares, Inc. in August 2007. Our Company owns all of the issued and outstanding capital stock of Union State Bancshares, Inc., which in turn owns all of the issued and outstanding capital stock of Hawthorn Bank. Our Company conducts operations primarily through our Bank. Our Bank, a state charted bank, had $\$ 1.24$ billion in assets at June 30, 2010, and 24 full-service banking offices, including its principal office in Jefferson City, Missouri. Our Bank is committed to providing the most
up-to-date financial products and services and delivering these products and services to our market area with superior customer service.

Through our branch network, our Bank 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. We also provide a wide range of lending services, including real estate, commercial, installment, and other consumer loans. Other financial services that we provide include automatic teller machines, trust services, credit related insurance, and safe deposit boxes. The geographic areas in which we provide our products and services include the communities in and surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee s Summit, Missouri. The products and services are offered to customers primarily within these geographical areas.

Our 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. Our Company also derives income from trust, brokerage, credit card and mortgage banking activities and service charge income.

## Critical Accounting Policies

The following accounting policies are considered most critical to the understanding of our Company sfinancial 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 our critical accounting policies on our business operations is discussed throughout Management s Discussion and Analysis of Financial Condition and Results of Operations, where such polices affect our reported and expected financial results.

## Allowance for Loan Losses

We have identified the accounting policy related to the allowance for loan losses as critical to the understanding of our 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. Collateral values and historical loss experience are significant inputs and estimates used to measure losses within the reserve methodology. The impact and any associated risks related to these policies on our business operations are discussed in the Lending and Credit Management section below.

## 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 an entity s financial statements or tax returns. Judgment is required in addressing our 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 forward, 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, our Company would adjust the recorded value of our deferred tax asset, which would result in a direct charge to income tax expense in the period that the determination was made. Likewise, our Company would reverse the valuation allowance when the realization of the deferred tax asset is expected. In addition, our Company is subject to the continuous examination of our tax returns by the Internal Revenue Service and other taxing authorities. Our Company accrues for interest related to income taxes in income tax expense. Total interest expense recognized for the six months ended June 30, 2010 and 2009 was $\$ 19,000$ and $\$ 44,000$, respectively. As of June 30, 2010 and December 31, 2009, total accrued interest was $\$ 113,000$ and $\$ 94,000$, respectively

## SELECTED CONSOLIDATED FINANCIAL DATA

The following table presents selected consolidated financial information for our Company as of and for each of the three month period ended June 30, 2010. The selected consolidated financial data should be read in conjunction with the Consolidated Financial Statements of our Company, including the accompanying notes, presented elsewhere herein.
Selected Financial Data

|  | Three Months <br> Ended <br> June 30, | Six Months <br> Ended <br> June 30, |  |  |
| :--- | ---: | ---: | ---: | ---: |
| (In thousands, except per share data) | $\mathbf{2 0 1 0}$ | $\mathbf{2 0 0 9}$ | $\mathbf{2 0 1 0}$ | $\mathbf{2 0 0 9}$ |
| Per Share Data |  |  |  |  |
| Basic earnings per common share | $\$ 0.06$ | $\$ 0.16$ | $\$ 0.06$ | $\$ 0.28$ |
| Diluted earnings per common share | 0.06 | 0.16 | 0.06 | 0.28 |
| Dividends paid on preferred stock | 378 | 378 | 756 | 613 |
| Amortization of discount on preferred stock | 119 | 119 | 238 | 238 |
| Dividends paid on common stock | 473 | 868 | 946 | 1,737 |
| Book value per common share |  |  | 17.93 | 17.54 |
| Market price common stock |  |  | 12.05 | 9.52 |

## Selected Ratios

(Based on average balance sheets)

| Return on average total assets | 0.25\% | 0.38\% | 0.21\% | 0.36\% |
| :---: | :---: | :---: | :---: | :---: |
| Return on average common stockholders equity | 1.41\% | 3.56\% | 0.72\% | 3.22\% |
| Average common stockholders equity to average total assets | 6.39\% | 6.26\% | 6.38\% | 6.25\% |
| (Based on end-of-period data) |  |  |  |  |
| Efficiency ratio (1) | 76.08\% | 75.34\% | 75.15\% | 74.27\% |
| Period-end stockholders equity to period-end assets |  |  | 6.47\% | 6.24\% |
| Period-end common stockholders equity to period-end assets |  |  | 8.78\% | 8.48\% |
| Total risk-based capital ratio |  |  | 17.07 | 16.18 |
| Tier 1 risk-based capital ratio |  |  | 14.54 | 13.68 |
| Leverage ratio |  |  | 11.31 | 10.98 |

(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

## Summary



Less: accretion of discount on preferred stock

$$
119
$$

119
238
238

## Net income available

## to common

 shareholders| $\$$ | 281 | $\$$ | 703 | $\$(422)$ | $(60.0) \%$ | $\$$ | 286 | $\$ 1,266$ | $\$(980)$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |$(77.4) \%$

Our Company s consolidated net income of \$782,000 for the three months ended June 30, 2010 decreased $\$ 422,000$, or $35.0 \%$, compared to the three months ended June 30 2009. Our Company recorded preferred stock dividends and accretion on preferred stock of $\$ 501,000$ in the three months ended June 30, 2010, resulting in $\$ 281,000$ of net income available to common shareholders, compared to $\$ 703,000$ for the three months ended June 30, 2009. Diluted earnings per share decreased from $\$ 0.16$ per common share to $\$ 0.06$ per common share. Results for the three months ended June 30, 2010 were negatively impacted by the $\$ 2,150,000$ provision for loan losses compared to $\$ 1,404,000$ for the same period in 2009. The decrease in noninterest income was primarily due to lower gain on sales of mortgage loans for the three months ended June 30, 2010 in comparison to the same time period in 2009. Our Company experienced substantial real estate refinancing activity that positively impacted noninterest income during 2009. For the three months ended June 30, 2010, the annualized return on average assets was $0.25 \%$, the annualized return on average common shareholders equity was $1.41 \%$, and the efficiency ratio was $76.1 \%$. Net interest margin increased from $3.42 \%$ to $3.88 \%$. Net interest income, on a tax equivalent basis, increased $\$ 1,079,000$ or $10.58 \%$ from 2009 to 2010.

Our Company s consolidated net income of $\$ 1,276,000$ for the six months ended June 30, 2010 decreased $\$ 985,000$, or $43.6 \%$, compared to the six months ended June 30, 2009. Our Company recorded preferred stock dividends and accretion on preferred stock of \$990,000 in the first six months of 2010, resulting in $\$ 286,000$ of net income available to common shareholders, compared to $\$ 1,266,000$ for the first six months of 2009. Diluted earnings per share decreased from $\$ 0.28$ per common share to $\$ 0.06$ per common share. Results for the six months ended

June 30, 2010 were negatively impacted by the $\$ 4,655,000$ provision for loan losses compared to $\$ 3,154,000$ for the same period in 2009. As mentioned above, the decrease in noninterest income was primarily due to lower gain on sales of mortgage loans due to a decrease real estate refinancing activity during the first six months ended June 30, 2010 in comparison to the same time period during 2009. For the six months June 30, 2010, the annualized return on average assets was $0.21 \%$, the annualized return on average common shareholders equity was $0.72 \%$, and the efficiency ratio was $75.1 \%$. Net interest margin increased from $3.37 \%$ to $3.74 \%$. Net interest income, on a tax equivalent basis, increased $\$ 1,848,000$ or $9.2 \%$ from 2009 to 2010. Total assets at June 30, 2010 were $\$ 1,239,543,000$, compared to $\$ 1,236,470,000$ at December 31, 2009, an increase of $\$ 3,073,000$, or $0.3 \%$.

## Net Interest Income

Net interest income is the largest source of revenue resulting from our Company s lending, investing, borrowing, and deposit gathering activities. It is affected by both changes in the level of interest rates and changes in the amounts and mix of interest earning assets and interest bearing liabilities.

## Average Balance Sheets

The following table presents average balance sheets, net interest income, average yields of earning assets, average costs of interest bearing liabilities, net interest spread and net interest margin on a fully taxable equivalent basis for each of the three month periods ended June 30, 2010 and 2009, respectively.

|  | Three Months Ended June 30, |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | 2010 |  |  | 2009 |  |
|  |  | Interest | Rate |  | Interest | Rate |
|  | Average | Income/ | Earned/ | Average | Income/ | Earned/ |
| (dollars in thousands) |  | Expense(1) | Paid(1) |  | Expense(1) | Paid(1) |

ASSETS
Loans (2)(4)
Commercial
Real estate construction residential
Real estate construction commercial
Real estate mortgage residential
Real estate mortgage commercial \$ 144,193 \$ 2,016
$5.61 \% \quad \$ 153,172$
\$ 2,075
5.43\%

| 39,211 | 506 | 5.18 | 46,939 | 526 | 4.49 |
| ---: | ---: | ---: | ---: | ---: | ---: |
| 77,201 | 774 | 4.02 | 73,581 | 859 | 4.68 |
| 229,888 | 3,223 | 5.62 | 285,192 | 3,546 | 4.99 |
| 435,181 | 6,422 | 5.92 | 417,074 | 6,908 | 6.64 |
| 35,876 | 723 | 8.08 | 32,386 | 657 | 8.14 |

Investment in securities:
(3)
U.S. Treasury
Government sponsored enterprises
Asset backed securities
State and municipal
Restricted investments
Federal funds sold
$1,000 \quad 5 \quad 2.01$

Interest bearing deposits in other financial institutions

Total interest earning

| assets | $1,166,390$ |
| :--- | ---: |
| All other assets | 96,857 |
| All | $(13,835)$ |

5.25

1,195,070
16,260
5.46

Allowance for loan losses
$(13,835)$
Total assets
\$1,249,412
\$1,270,609

## LIABILITIES AND

STOCKHOLDERS
EQUITY

| NOW accounts | $\$$ | 179,887 | $\$$ | 257 | $0.57 \%$ | $\$$ | 137,531 | $\$$ |
| :--- | ---: | ---: | :--- | ---: | ---: | ---: | ---: | :--- |
| Savings | 52,789 |  | 32 | 0.24 |  | 46,116 | 35 | $0.87 \%$ |
| Money market | 168,671 |  | 265 | 0.63 |  | 173,652 |  | 434 |
|  | 131,508 |  | 651 | 1.99 | 141,610 | 1,027 | 2.91 |  |

Time deposits of $\$ 100,000$ and over

| Other time deposits | 320,546 | 1,851 | 2.32 | 367,712 | 2,839 | 3.10 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Total time deposits | 853,401 | 3,056 | 1.44 | 866,621 | 4,633 | 2.14 |
| Federal funds purchased and securities sold under agreements to repurchase | 33,023 | 19 | 0.23 | 31,612 | 18 | 0.23 |
| Subordinated notes | 49,486 | 323 | 2.62 | 49,486 | 628 | 5.09 |
| Other borrowed money | 68,575 | 591 | 3.46 | 79,174 | 784 | 3.97 |
| Total interest bearing |  |  |  |  |  |  |
| liabilities | 1,004,485 | 3,989 | 1.59 | 1,026,893 | 6,063 | 2.37 |
| Demand deposits | 129,448 |  |  | 125,834 |  |  |
| Other liabilities | 7,145 |  |  | 10,727 |  |  |
| Total liabilities | 1,141,078 |  |  | 1,163,454 |  |  |
| Stockholders equity | 108,334 |  |  | 107,155 |  |  |
| Total liabilities and stockholders equity | \$1,249,412 |  |  | \$1,270,609 |  |  |
| Net interest income (FTE) |  | \$11,276 |  |  | \$ 10,197 |  |
| Net interest spread |  |  | 3.66\% |  |  | 3.09\% |
| Net interest margin |  |  | 3.88\% |  |  | 3.42\% |
| (1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of $35 \%$, net of nondeductible interest expense. Such adjustments totaled $\$ 162,000$ and $\$ 179,000$ for the three months ended June 30, 2010 and 2009, respectively. |  |  |  |  |  |  |

(2)

Non-accruing loans are
included in the
average
amounts
outstanding.
(3) Average
balances based
on amortized
cost.
(4) Fees and costs
on loans are
included in
interest income.

|  |  |  | Months | June |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | 2010 |  |  | 2009 |  |
|  |  | Interest | Rate |  | Interest | Rate |
|  | Average | Income/ | Earned/ | Average | Income/ | Earned/ |
| (dollars in thousands) | Balance | Expense(1) | Paid(1) | Balance | Expense(1) | Paid(1) |


| ASSETS |  |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Loans (2)(4) |  |  |  |  |  |  |  |  |  |  |
| Commercial | \$ | 146,211 | \$ | 4,010 | 5.53\% | \$ | 151,854 | \$ | 4,077 | 5.41\% |
| Real estate construction residential |  | 38,979 |  | 1,015 | 5.25 |  | 31,826 |  | 1,129 | 7.15 |
| Real estate construction commercial |  | 77,234 |  | 1,431 | 3.74 |  | 50,061 |  | 1,865 | 7.51 |
| Real estate mortgage residential |  | 230,817 |  | 6,473 | 5.66 |  | 207,024 |  | 7,200 | 7.01 |
| Real estate mortgage commercial |  | 441,870 |  | 12,766 | 5.83 |  | 535,724 |  | 13,489 | 5.08 |
| Consumer |  | 36,135 |  | 1,418 | 7.91 |  | 32,762 |  | 1,278 | 7.87 |
| Investment in securities: (3) |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | 542 |  | 5 | 1.86 |  |  |  |  |  |
| Government sponsored enterprises |  | 45,670 |  | 645 | 2.85 |  | 49,244 |  | 951 | 3.89 |
| Asset backed securities |  | 80,971 |  | 1,505 | 3.75 |  | 60,155 |  | 1,284 | 4.30 |
| State and municipal |  | 34,294 |  | 934 | 5.49 |  | 39,825 |  | 1,110 | 5.62 |
| Restricted investments |  | 6,486 |  | 85 | 2.64 |  | 8,875 |  | 56 | 1.27 |
| Federal funds sold |  | 169 |  |  |  |  | 331 |  |  |  |
| Interest bearing deposits in other |  |  |  |  |  |  |  |  |  |  |
| Total interest earning assets |  | 1,172,800 |  | 30,323 | 5.21 |  | 1,191,415 |  | 32,471 | 5.50 |
| All other assets |  | 95,365 |  |  |  |  | 88,800 |  |  |  |
| Allowance for loan losses |  | $(14,377)$ |  |  |  |  | $(13,021)$ |  |  |  |
| Total assets |  | 1,253,788 |  |  |  |  | 1,267,194 |  |  |  |
| LIABILITIES AND |  |  |  |  |  |  |  |  |  |  |
| STOCKHOLDERS EQUITY |  |  |  |  |  |  |  |  |  |  |
| NOW accounts | \$ | 178,321 | \$ | 533 | 0.60\% | \$ | 140,585 | \$ | 634 | 0.91\% |
| Savings |  | 51,047 |  | 64 | 0.25 |  | 45,258 |  | 71 | 0.32 |
| Money market |  | 169,081 |  | 588 | 0.70 |  | 175,466 |  | 992 | 1.14 |
| Time deposits of |  |  |  |  |  |  |  |  |  |  |
| \$100,000 and over |  | 133,827 |  | 1,720 | 2.59 |  | 140,083 |  | 2,108 | 3.03 |
| Other time deposits |  | 323,733 |  | 3,491 | 2.17 |  | 362,293 |  | 5,779 | 3.22 |
| Total time deposits |  | 856,009 |  | 6,396 | 1.51 |  | 863,685 |  | 9,584 | 2.24 |
| Federal funds purchased and securities sold under agreements to |  |  |  |  |  |  |  |  |  |  |
| repurchase |  | 33,377 |  | 40 | 0.24 |  | 30,485 |  | 40 | 0.26 |
| Subordinated notes |  | 49,486 |  | 848 | 3.46 |  | 49,486 |  | 1,290 | 5.26 |
| Other borrowed money |  | 73,081 |  | 1,267 | 3.50 |  | 84,078 |  | 1,633 | 3.92 |
| Total interest bearing liabilities |  | 1,011,953 |  | 8,551 | 1.70 |  | 1,027,734 |  | 12,547 | 2.46 |
| Demand deposits |  | 126,290 |  |  |  |  | 122,247 |  |  |  |


| Other liabilities | 7,108 |  | 10,001 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Total liabilities | 1,145,351 |  | 1,159,982 |  |  |
| Stockholders equity | 108,437 |  | 107,212 |  |  |
| Total liabilities and stockholders equity | \$ 1,253,788 |  | \$ 1,267,194 |  |  |
| Net interest income (FTE) |  | \$21,772 |  | \$19,924 |  |
| Net interest spread <br> Net interest margin |  | $\begin{aligned} & 3.51 \% \\ & 3.74 \% \end{aligned}$ |  |  | $\begin{aligned} & 3.04 \% \\ & 3.37 \% \end{aligned}$ |
| (1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of $35 \%$, net of nondeductible interest expense. Such adjustments totaled \$347,000 and $\$ 376,000$ for the three months ended June 30, 2010 and 2009, respectively. |  |  |  |  |  |
| (2) Non-accruing loans are included in the average amounts outstanding. |  |  |  |  |  |
| (3) Average balances based on amortized cost. |  |  |  |  |  |
| (4) Fees and costs on loans are included in interest income. |  |  |  |  |  |

## Comparison of the three months ended June 30, 2010 and 2009

Financial results for the second quarter of 2010 compared to 2009 included an increase in net interest income, on a tax equivalent basis of $\$ 1,079,000$, or $10.6 \%$. Average interest-earning assets decreased $\$ 28,680,000$, or $2.4 \%$, to $\$ 1,166,390,000$ for the three months ended June 30, 2010 compared to $\$ 1,195,070,000$ for the three months ended June 30, 2009. Average interest bearing liabilities decreased $\$ 22,408,000$, or $2.18 \%$, to $\$ 1,004,485,000$ for the three months ended June 30, 2010 compared to $\$ 1,026,893,000$ for the three months ended June 30, 2009.

Average loans outstanding decreased $\$ 46,794,000$ or $4.6 \%$ to $\$ 961,550,000$ for the three months ended 2010 compared to $\$ 1,008,344,000$ for the three months ended June 30, 2009. See the Lending and Credit Management section below for further discussion. The following is a summary of the changes in average loan balance by major category:

## (Dollars in thousands) 2010

## Average loans:

Commercial
Real estate construction residential
Real estate construction commercial
Real estate mortgage residential
Real estate mortgage commercial Consumer

## Total

## Three Months Ended June 30, 2009 \$ Change

\% Change4.9

10.8
(4.6)\%

Average investment securities and federal funds sold increased $\$ 14,664,000$, or $9.9 \%$, to $\$ 162,718,000$ for the three months ended June 30, 2010 compared to $\$ 148,054,000$ for the three months ended June 30, 2009. Average interest bearing deposits increased $\$ 6,079,000$ to $\$ 35,876,000$ for the three months ended June 30,2010 compared to $\$ 29,797,000$ for the three months ended June 30, 2009. See the Liquidity Management section below for further discussion.

The overall decrease in average interest bearing liabilities was due to a decrease in time deposits and other borrowed money. Average time deposits decreased $\$ 13,220,000$, or $1.5 \%$, to $\$ 853,401,000$ for the three months ended June 30, 2010 compared to $\$ 866,621,000$ for the three months ended June 30, 2009. Average other borrowed money decreased $\$ 10,599,000$, or $13.4 \%$, to $\$ 68,575,000$ for the three months ended June 30,2010 compared to $\$ 79,174,000$ for the three months ended June 30, 2009. The decrease reflects a net decrease in Federal Home Loan Bank advances.

## Comparison of the six months ended June 30, 2010 and 2009

Financial results for the six months ended June 30, 2010 compared to 2009 included an increase in net interest income, on a tax equivalent basis of $\$ 1,848,000$, or $9.3 \%$. Average interest-earning assets decreased $\$ 18,615,000$, or $1.6 \%$, to $\$ 1,172,800,000$ for the six months ended June 30,2010 compared to $\$ 1,191,415,000$ for the six months ended June 30, 2009. Average interest bearing liabilities decreased $\$ 15,781,000$, or $1.54 \%$, to $\$ 1,011,953,000$ for the six months ended June 30, 2010 compared to $\$ 1,027,734,000$ for the six months ended June 30, 2009.

Average loans outstanding decreased $\$ 38,005,000$ or $3.8 \%$ to $\$ 971,246,000$ for the six months ended 2010 compared to $\$ 1,009,251,000$ for the six months ended June 30, 2009. See the Lending and Credit Management section below for further discussion. The following is a summary of the changes in average loan balance by major category:

|  | Six Months Ended June 30, |  |  |  |
| :--- | :---: | :---: | :---: | :---: | ---: |
| (Dollars in thousands) | $\mathbf{2 0 1 0}$ | $\mathbf{2 0 0 9}$ | \$ Change | \% Change |
| Average loans: <br> Commercial | $\$ 146,211$ | $\$ 151,854$ | $\$(5,643)$ | $(3.7) \%$ |

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| Real estate construction | residential | 38,979 | 31,826 | 7,153 | 22.5 |
| :--- | :--- | ---: | ---: | ---: | :---: |
| Real estate construction | commercial | 77,234 | 50,061 | 27,173 | 54.3 |
| Real estate mortgage | residential | 230,817 | 207,024 | 23,793 | 11.5 |
| Real estate mortgage | commercial | 441,870 | 535,724 | $(93,854)$ | $(17.5)$ |
| Consumer |  | 36,135 | 32,762 | 3,373 | 10.3 |
| Total |  | $\$ 971,246$ | $\$ 1,009,251$ | $\$(38,005)$ | $(3.8) \%$ |

Average investment securities and federal funds sold increased $\$ 12,091,000$, or $8.1 \%$, to $\$ 161,646,000$ for the six months ended June 30, 2010 compared to $\$ 149,555,000$ for the six months ended June 30, 2009. Average interest bearing deposits increased $\$ 9,688,000$ to $\$ 33,422,000$ for the six months ended June 30, 2010 compared to $\$ 23,734,000$ for the six months ended June 30, 2009. See the Liquidity Management section below for further discussion.

The overall decrease in average interest bearing liabilities was due to a decrease in time deposits and other borrowed money. Average time deposits decreased $\$ 7,676,000$, or $0.9 \%$, to $\$ 856,009,000$ for the six months ended June 30, 2010 compared to $\$ 863,685,000$ for the six months ended June 30, 2009. Average federal funds purchased and securities sold under agreements to repurchase increased $\$ 2,892,000$, or $9.5 \%$, to $\$ 33,377,000$ for 2010 compared to $\$ 30,485,000$ for 2009. The increase consisted of $\$ 3,167,000$ increase in repurchase agreements, and a $\$ 275,000$ decrease in federal funds purchased. Average other borrowed money decreased $\$ 10,997,000$, or $13.1 \%$, to $\$ 73,081,000$ for 2010 compared to $\$ 84,078,000$ for 2009. The decrease in 2010 reflects a net decrease in Federal Home Loan Bank advances.

## Rate and volume analysis

The following table summarizes the changes in net interest income on a fully taxable equivalent basis, by major category of interest earning assets and interest bearing liabilities, identifying changes related to volumes and rates for the three and six months ended June 30, 2010 compared to June 30, 2009. The change in interest due to the combined rate/volume variance has been allocated to rate and volume changes in proportion to the absolute dollar amounts of change in each.

|  | Three Months Ended June 30, 2010 vs. 2009 Change due to |  |  | Six Months Ended June 30, 2010 vs. 2009 Change due to |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |  |
| (Dollars In thousands) | Total Change | Average Volume | Average <br> Rate | Total Change | Average Volume | Average Rate |

Interest income on a fully taxable equivalent basis:
Loans: (1) (3)
Commercial
Real estate construction residential
\$ (59) $\$(122) \quad \$ \quad 63 \quad \$ \quad(67) \quad \$(151) \quad \$ 84$

Real estate construction commercial
Real estate mortgage residential (20)

| $(85)$ | 40 | $(125)$ | $(434)$ | 748 | $(1,182)$ |
| ---: | ---: | ---: | :---: | :---: | ---: |
| $(323)$ | $(741)$ | 418 | $(727)$ | 767 | $(1,494)$ |
| $(486)$ | 291 | $(777)$ | $(723)$ | $(2,552)$ | 1,829 |
| 66 | 71 | $(5)$ | 140 | 133 | 7 |

Investment securities:
U.S. Treasury

Government sponsored entities
Asset backed securities
State and municipal(2)
(124)

Restricted investments (82)

Federal funds sold Interest bearing deposits in other financial institutions
(541)

$$
(2,148)
$$

(653)

$$
(1,495)
$$

## Interest expense:

NOW accounts
Savings
Money market

| $(41)$ | 77 | $(118)$ | $(101)$ | 145 | $(246)$ |
| ---: | ---: | ---: | ---: | ---: | ---: |
| $(3)$ | 5 | $(8)$ | $(7)$ | 8 | $(15)$ |
| $(169)$ | $(12)$ | $(157)$ | $(404)$ | $(35)$ | $(369)$ |
| $(376)$ | $(69)$ | $(307)$ | $(388)$ | $(91)$ | $(297)$ |
| $(988)$ | $(333)$ | $(655)$ | $(2,288)$ | $(566)$ | $(1,722)$ |
|  |  |  |  |  |  |
| 1 | 1 |  |  | 4 | $(4)$ |
| $(305)$ |  | $(305)$ | $(442)$ |  | $(442)$ |

Other borrowed money

Total interest expense
(193)

Net interest income on a fully $\begin{array}{lllllllllllllll}\text { taxable equivalent basis } & \$ 1,079 & \$ & (25) & \$ 1,104 & \$ 1,848 & \$ & 83 & \$ & 1,765\end{array}$
(1) Interest income and yields are presented on a
fully taxable
equivalent basis
using the
Federal
statutory income
tax rate of $35 \%$, net of
nondeductible
interest expense.
Such
adjustments totaled
\$162,000 and
$\$ 347,000$, and
\$179,000 and
$\$ 376,000$ for the
three and six
months ended
June 30, 2010
and 2009,
respectively.
(2) Non-accruing
loans are
included in the
average
amounts
outstanding.
(3) Fees and costs
on loans are
included in
interest income.
Net interest income on a fully taxable equivalent basis increased $\$ 1,079,000$, or $10.6 \%$, to $\$ 11,276,000$ for the three months ended June 30, 2010 compared to $\$ 10,197,000$ for the three months ended June 30, 2009. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) increased from $3.42 \%$ for the three months ended June 30,2009 to $3.88 \%$ for the three months ended June 30, 2010. This increase is primarily the result of a decrease in average earning liabilities. Our Company s net interest spread increased from $3.09 \%$ during the three months ended June 30,2009 to $3.66 \%$ during the same time period in 2010. While our Company was able to decrease the rate paid on interest bearing liabilities to $1.59 \%$ during the three months ended

June 30, 2010 from $2.37 \%$ during the same time period in 2009, this decrease was partially offset by a decrease in the rates earned on interest bearing assets from $5.46 \%$ in 2009 to $5.25 \%$ in 2010.

Net interest income on a fully taxable equivalent basis increased $\$ 1,848,000$, or $9.3 \%$, to $\$ 21,772,000$ for the six months ended June 30, 2010 compared to $\$ 19,924,000$ for the six months ended June 30, 2009. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) increased from $3.37 \%$ for the six months ended June 30, 2009 to $3.74 \%$ for the six months ended June 30, 2010. This increase is primarily the result of a decrease in average earning liabilities. Our Company s net interest spread increased from $3.04 \%$ during the six months ended June 30, 2009 to $3.51 \%$ during the same time period in 2010. While our Company was able to decrease the rate paid on interest bearing liabilities to $1.70 \%$ during the six months ended June 30, 2010 from $2.46 \%$ during the same time period in 2009, this decrease was partially offset by a decrease in the rates earned on interest bearing assets from $5.50 \%$ in 2009 to $5.21 \%$ in 2010.
Non-interest Income and Expense
Non-interest income

| (Dollars in thousands) | 2010 | Three Months Ended June 30, |  |  |  | 2010 | Six Months Ended June 30, |  | \% <br> Change |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Non-interest Income |  |  |  |  |  |  |  |  |  |
| Service charges on deposit | \$ 1,427 | \$ 1,455 | \$ |  | (1.9)\% | \$2,723 | \$ 2,833 | \$ (110) | (3.9)\% |
| Trust department income | 201 | 184 |  | 17 | 9.2 | 380 | 385 | (5) | (1.3) |
| Gain on sales of mortgage loans | 297 | 927 |  | (630) | (68.0) | 522 | 1,948 | $(1,426)$ | (73.2) |
| Other | 525 | 241 |  | 284 | 117.8 | 831 | 406 | 425 | 104.7 |
| Total non-interest income | \$ 2,450 | \$ 2,807 | \$ | (357) | (12.7)\% | \$4,456 | \$ 5,572 | \$ $(1,116)$ | (20.0)\% |
| Non-interest income as a \% of total revenue* | 18.1\% | 21.9\% |  |  |  | 17.2\% | 22.2\% |  |  |
| Total revenue per full time equivalent employee | \$ 38.6 | \$ 36.0 |  |  |  | \$ 73.7 | \$ 70.6 |  |  |

* Total revenue is calculated as net interest income plus non-interest income
Three Months Ended June 30, 2010 and 2009
Noninterest income for the three months ended June 30, 2010 was $\$ 2,450,000$ compared to $\$ 2,807,000$ for the three months ended June 30, 2009, resulting in a $\$ 357,000$, or $12.7 \%$, decrease. The decrease was primarily the result of a $\$ 630,000$ decrease in the gains on sales of mortgage loans due to decreased refinancing activity. Other income increased $\$ 284,000$, or $117.8 \%$, to $\$ 525,000$ compared to the prior period, primarily due to a $\$ 178,000$ increase in credit card income, of which $\$ 167,000$ was due to a nonmaterial correction, $\$ 119,000$ decrease in amortization of mortgage loan servicing rights offset by a $\$ 13,000$ decrease in real estate servicing fees.
Six Months Ended June 30, 2010 and 2009


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Noninterest income for the six months ended June 30, 2010 was $\$ 4,456,000$ compared to $\$ 5,572,000$ for the six months ended June 30, 2009, resulting in a $\$ 1,116,000$, or $20.0 \%$, decrease. The decrease was primarily the result of a $\$ 1,426,000$ decrease in the gains on sales of mortgage loans due to decreased refinancing activity. Other income increased $\$ 425,000$, or $104.7 \%$, to $\$ 831,000$ compared to the prior period, primarily due to a $\$ 185,000$ increase in credit card income, of which $\$ 167,000$ was due to a nonmaterial correction, $\$ 303,000$ decrease in amortization of mortgage loan servicing rights offset by a $\$ 47,000$ decrease in real estate servicing fees.

## Non-interest expense



## Three Months Ended June 30, 2010 and 2009

Noninterest expense for the three months ended June 30, 2010 was $\$ 10,320,000$ compared to $\$ 9,661,000$ for the three months ended June 30,2009 resulting in a $\$ 659,000$, or $6.8 \%$, increase. Employee benefits expense decreased $\$ 63,000$, or $5.9 \%$, furniture and equipment expenses decreased $\$ 189,000$, or $26.1 \%$, Federal Deposit Insurance Corporation (FDIC) insurance assessment decreased $\$ 548,000$, or $55.7 \%$, and other real estate expense increased $\$ 1,335,000$, or $780.7 \%$. The decrease in employee benefits expense was primarily due to a $\$ 63,000$ decrease in our Company s profit sharing accrual. The decrease in the FDIC insurance assessment is a result an increase in a special assessment during the second quarter of 2009 . The $\$ 1,335,000$ increase in other real estate expense reflects expenses incurred on the maintenance and preparation for sale on the increase in foreclosed property, including $\$ 1,172,000$ in impairment charges compared to $\$ 62,000$ during 2009.
Six Months Ended June 30, 2010 and 2009

Noninterest expense for the six months ended June 30,2010 was $\$ 19,450,000$ compared to $\$ 18,656,000$ for the six months ended June 30,2009 resulting in a $\$ 794,000$, or $4.3 \%$, increase. Salary expense increased $\$ 279,000$, or $4.1 \%$, furniture and equipment expenses decreased $\$ 261,000$, or $20.3 \%$, Federal Deposit Insurance Corporation (FDIC) insurance assessment decreased $\$ 819,000$, or $49.2 \%$, and other real estate expense increased $\$ 1,678,000$, or $500.9 \%$. The increase in salary expense is a result of $\$ 270,000$ increase in salaries, $\$ 156,000$ decrease in incentives, and $\$ 185,000$ decrease in deferred loan costs. The decrease in furniture and equipment expense primarily was due to a $\$ 186,000$ net loss on the sale of one of our Company s branch buildings in June of 2009. The decrease in the FDIC insurance assessment is a result of a decrease in the estimated expense accrued during 2010 in comparison to 2009 and an increase in special assessments during 2009. The $\$ 1,678,000$ increase in other real estate expense reflects expenses incurred on the maintenance and preparation for sale on the increase in foreclosed property, including $\$ 1,235,000$ in impairment charges compared to $\$ 62,000$ during 2009.

## Income Taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were $28.5 \%$ for the three months ended June 30,2010 compared to $31.6 \%$ for the three months ended June 30, 2009. The effective tax rate during the second quarter of 2010 reflects the increase in tax-exempt income as a percentage of total taxable income.

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were $28.1 \%$ for the six months ended June 30 , 2010 compared to $31.7 \%$ for the six months ended June 30, 2009. The effective tax rate during the second quarter of 2010 reflects the increase in tax-exempt income as a percentage of total taxable income.

## Lending and Credit Management

Interest earned on the loan portfolio is a primary source of interest income for our Company. Net loans represented $75.2 \%$ of total assets as of June 30, 2010 compared to $79.0 \%$ as of December 31, 2009.

Lending activities are conducted pursuant to an established loan policy approved by our Bank s Board of Directors. The Bank s credit review process is comprised of a regional loan committee with an established approval limit. In addition, a senior loan committee reviews all credit relationships in aggregate over an established dollar amount. The senior loan committee meets weekly and is comprised of senior managers of the Bank.

The following table shows the composition of the loan portfolio by major category and each category as a percentage of the total portfolio as of the dates indicated.

| (In thousands) | June 30, 2010 |  | $\begin{gathered} \text { December 31, } \\ 2009 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Amount | \% | Amount | \% |
| Commercial, financial, and agricultural | \$ 140,227 | 14.8\% | \$ 151,399 | 15.3\% |
| Real estate construction residential | 37,710 | 4.0 | 38,841 | 3.9 |
| Real estate construction commercial | 76,868 | 8.1 | 77,937 | 7.9 |
| Real estate mortgage residential | 221,226 | 23.4 | 232,332 | 23.4 |
| Real estate mortgage commercial | 433,733 | 45.9 | 453,975 | 45.8 |
| Installment loans to individuals | 34,700 | 3.7 | 36,966 | 3.7 |
| Deferred fees | 188 | 0.0 | 164 | 0.0 |
| Total loans | \$ 944,652 | 100.0\% | \$ 991,614 | 100.0\% |

Our Company s loan portfolio decreased $\$ 46,962,000$, or $4.7 \%$, from December 31, 2009 to June 30, 2010. This decrease was primarily a result of a decrease in commercial loans of $\$ 11,170,000$, or $7.4 \%$, a decrease in real estate mortgage residential loans of $\$ 11,106,000$, or $4.8 \%$, a decrease in real estate mortgage commercial loans of $\$ 20,242,000$, or $4.5 \%$, and a decrease in individual consumer loans of $\$ 2,266,000$, or $6.1 \%$. The decrease in commercial loans primarily reflects the payoff of two large commercial credits. The decrease in individual consumer loans reflects the payoff of one large consumer loan which was secured by a Bank certificate of deposit. In addition we had other large payoffs totaling approximately $\$ 4,262,000$ in other categories. Also contributing to the decrease in total loans were gross charge-offs of $\$ 7,567,000$ and $\$ 11,750,000$ of assets transferred from loans to other real estate owned and repossessed assets. During the current down-turn in the economy, management continues to focus on the improvement of asset quality. Management has tightened underwriting standards and is focused on lending to credit worthy borrowers with the capacity to service the debts. Where appropriate, management actively works with existing borrowers to modify loan terms and conditions in order to assist the borrowers in servicing their debt obligations to our Company. The decrease in lending activities in the real estate construction market also reflects the slow down in the housing industry and residential construction industry as well as foreclosures on various residential construction properties. Construction lending will continue to be closely monitored.

Our Company does not extend credit to sub-prime residential real estate markets. While much publicity has been directed at this market during recent years, our Company extends credit to its local community market through traditional mortgage products.

Our Company generally does not retain long-term fixed rate residential mortgage loans in its portfolio. Fixed rate loans conforming to standards required by the secondary market are offered to qualified borrowers, but are not
funded until our Company has a non-recourse purchase commitment from the secondary market at a predetermined price. At June 30, 2010 our Company was servicing approximately $\$ 273,237,000$ of loans sold to the secondary market.

Mortgage loans retained in our Company s portfolio generally include provisions for rate adjustments at one to three year intervals. Commercial loans and real estate construction loans generally have maturities of less than one year. Installment loans to individuals are primarily fixed rate loans with maturities from one to five years.

The provision for loan losses is based on management s evaluation of the loan portfolio in light of national and local economic conditions, changes in the composition and volume of the loan portfolio, changes in the volume of past due and nonaccrual loans, the value of underlying collateral and other relevant factors. The allowance for loan losses which is reported as a deduction from loans is available for loan charge-offs. This allowance is increased by the provision charged to expense and is reduced by loan charge-offs, net of loan recoveries.

Management along with senior loan committee, and internal loan review, formally review all loans in excess of certain dollar amounts (periodically established) at least annually. Currently, loans in excess of $\$ 2,000,000$ in aggregate and all adversely classified credits identified by management as containing more than usual risk are reviewed. In addition, loans below the above scope are reviewed on a sample basis. On a monthly basis, the senior loan committee reviews and reports to the Board of Directors past due, classified, and watch list loans in order to classify or reclassify loans as loans requiring attention, substandard, doubtful, or loss. During this review, management also determines which loans should be considered impaired. Management follows the guidance provided in the FASB s ASC Topic 310, Accounting by Creditors for Impairment of a Loan, in identifying and measuring loan impairment. 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. Once a loan has been identified as impaired management generally measures impairment based upon the fair value of the underlying collateral. Management believes, but there can be no assurance, that these procedures keep management informed of possible problem loans. Based upon these procedures, both the allowance and provision for loan losses are adjusted to maintain the allowance at a level considered adequate by management for probable losses inherent in the loan portfolio.

## Provision and Allowance for Loan Losses

The provision for loan losses increased $\$ 1,501,000$ or $47.6 \%$ to $\$ 4,655,000$ for the six months ended June 30, 2010 compared to $\$ 3,154,000$ for the six months ended June 30, 2009. The current economy has contributed to the deterioration of collateral values. Our Company has taken an active approach to obtain current appraisals and has adjusted the provision to reflect the amounts management determined necessary to maintain the allowance for loan losses at a level adequate to cover probable losses in the loan portfolio. However, due to charge offs taken during the first six months of 2010, the allowance for loan losses decreased to $\$ 12,232,000$ or $1.3 \%$ of loans outstanding at June 30, 2010 compared to $\$ 14,797,000$ or $1.5 \%$ of loans outstanding at December 31, 2009. The allowance for loan losses expressed as a percentage of nonperforming loans was $24.0 \%$ at June 30, 2010 and $34.9 \%$ at December 31, 2009.

The following table summarizes loan loss experience for the periods indicated:
(Dollars in thousands)
|।||

## Provision for loan losses

Net loan charge-offs:

| Commercial, financial, and agricultural | 612 | 165 | 1,104 | 260 |
| :--- | ---: | ---: | ---: | ---: |
| Real estate construction | residential | $(22)$ | 374 | 259 |
| Real estate construction | commercial | 22 |  | 101 |
| Real estate mortgage residential | 1,591 | 86 | 3,319 | 289 |
| Real estate mortgage commercial | 2,319 | 166 | 2,337 | 692 |
| Installment loans to individuals | 54 | 67 | 100 | 108 |
| Total net loan charge-offs | $\$ 4,576$ | $\$ 858$ | $\$ 7,220$ | $\$ 2,116$ |

As shown in the table above, our Company experienced net loan charge-offs of \$7,220,000 during the first six months of 2010 and $\$ 2,116,000$ during the first six months of 2009 . Net charge offs on commercial, financial, and agricultural loans increased $\$ 844,000$ from June 30, 2009 to June 30, 2010, and was primarily due to two write-downs taken on two loans to reflect current collateral values. Net charge offs on real estate mortgage residential properties increased $\$ 2,627,000$ from June 30, 2009 to June 30, 2010 and was primarily due to write-downs taken on foreclosed properties, from one significant customer relationship, to reflect current collateral values. Net charge offs on real estate mortgage commercial properties increased \$2,131,000 from June 30, 2009 to June 30, 2010 and was primarily due to
write-downs taken on four loans to reflect current collateral values. The ratio of annualized total net loan charge-offs to total average loans was $.21 \%$ at June 30, 2009 compared to $.74 \%$ at June 30, 2010.

Nonperforming loans, defined as loans on nonaccrual status, loans 90 days or more past due and still accruing interest, and restructured troubled loans totaled $\$ 62,132,000$ or $6.58 \%$ of total loans at June 30, 2010 compared to $\$ 42,347,000$ or $4.27 \%$ of total loans at December 31, 2009.
The following table summarizes our Company s nonperforming assets at the dates indicated:

| (Dollars in thousands) | $\begin{gathered} \text { June 30, } \\ 2010 \end{gathered}$ | $\begin{gathered} \text { December } \\ \text { 31, } \\ 2009 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: |
| Nonaccrual loans: |  |  |  |
| Commercial, financial, and agricultural | \$ 1,369 | \$ | 2,067 |
| Real estate construction residential | 3,187 |  | 2,678 |
| Real estate construction commercial | 20,435 |  | 9,277 |
| Real estate mortgage residential | 5,662 |  | 6,692 |
| Real estate mortgage commercial | 15,023 |  | 13,161 |
| Installment loans to individuals | 149 |  | 279 |
| Total nonaccrual loans | 45,825 |  | 34,154 |
| Loans contractually past due 90 days or more and still accruing: |  |  |  |
| Commercial, financial, and agricultural | 201 |  | 2 |
| Real estate mortgage residential | 83 |  |  |
| Real estate mortgage commercial | 23 |  |  |
| Installment loans to individuals | 2 |  |  |
| Total loans contractually past -due 90 days or more and still accruing | 309 |  | 2 |
| Troubled debt restructured loans | 15,998 |  | 8,191 |
| Total nonperforming loans | 62,132 |  | 42,347 |
| Other real estate and repossessions | 14,204 |  | 8,491 |
| Total nonperforming assets | \$ 76,336 | \$ | 50,838 |
| Loans | \$ 944,652 | \$ | 991,614 |
| Allowance for loan losses to loans | 1.29\% |  | 1.49\%\% |
| Nonperforming loans to loans | 6.58\% |  | 4.27\%\% |
| Allowance for loan losses to nonperforming loans | 19.69\% |  | 34.94\%\% |
| Nonperforming assets to loans and foreclosed assets | 7.95\% |  | 5.08\%\% |

It is our Company s policy to discontinue the accrual of interest income on loans when the full collection of principal or interest is in doubt, or when the payment of principal or interest has become contractually 90 days past due unless the obligation is 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 collectibles of such principal; otherwise, such receipts are recorded as interest income. Interest on nonaccrual loans, which would have been recorded under the original terms of the loans, was approximately $\$ 1,278,000$ and $\$ 645,000$ for the six months ended June 30, 2010 and 2009 , respectively. Approximately $\$ 4,000$ and $\$ 21,000$ was recorded as interest income on such loans for the six months ended June 30, 2010 and 2009, respectively.

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Total non-accrual loans at June 30, 2010 increased $\$ 11,671,000$ from December 31, 2009. The increase resulted primarily from an increase of $\$ 11,158,000$ in construction commercial non-accrual loans. This increase primarily represents four commercial customers with balances totaling $\$ 14,352,000$. Although our non-accrual loans significantly increased from $\$ 34,154,000$ at December 31, 2009 to $\$ 45,825,000$ at June 30, 2010, total impaired loans decreased $\$ 10,805,000$. The increase in nonaccrual loans did not impact total impaired loans or reserves for impaired loans as these loans were previously classified as impaired and adequately reserved for at December of 2009. The balance of impaired loans without reserves is $51 \%$ of total impaired loans at June 30, 2010 and $64 \%$ at December 31, 2009. Management believes the excess value in the collateral was sufficient at June 30, and December 31, and these loans did not require additional reserves.

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Loans past due 90 days and still accruing interest increased \$307,000 from December 31, 2009 to June 30, 2010. Foreclosed real estate and other repossessions increased $\$ 5,713,000$ to $\$ 14,204,000$. At June 30, 2010, loans classified as troubled debt restructured loans (TDR) totaled $\$ 19,449,000$, of which $\$ 3,451,000$ was on non-accrual status and $\$ 15,998,000$ was on accrual status. At December 31, 2009, loans classified as TDR totaled $\$ 11,233,000$, of which $\$ 3,042,000$ was on non-accrual status and $\$ 8,191,000$ was on accrual status. The increase in TDR loans is primarily reflected by one large hotel credit of $\$ 11,091,000$.

The ratio of nonperforming loans to loans increased from $4.27 \%$ at December 31, 2009 to $6.58 \%$ at June 30, 2010. Our Company has experienced an increase in its loan delinquencies much like the rest of the banking industry as current economic conditions negatively impact our borrowers ability to keep their debt payments current.

The increase in the levels of charge offs has contributed to the decrease in the ratio of allowance for loan losses to nonperforming loans from $46.56 \%$ at June 30, 2009 to $34.94 \%$ at December 31, 2009, and to $19.69 \%$ at June 30, 2010. Management believes that based on detailed analysis of each nonperforming credit and the value of any associated collateral that the allowance for loan losses at June 30, 2010 is sufficient to cover probable losses in the nonperforming loans.

A loan is considered impaired when it is probable a creditor will be unable to collect all amounts due both principal and interest according to the contractual terms of the loan agreement. In addition to nonaccrual loans at June 30, 2010 included in the table above, which were considered impaired, management has identified additional loans totaling approximately $\$ 17,236,000$ which were not included in the nonaccrual table above but are considered by management to be impaired compared to $\$ 39,713,000$ at December 31, 2009. Management has allocated $\$ 795,000$ of reserves for these credits.

Once a loan has been identified as impaired, management generally measures impairment based upon the fair value of the underlying collateral. In general, market prices for loans in our portfolio are not available, and we have found the fair value of the underlying collateral to be more readily available and reliable than discounting expected future cash flows to be received. Once the fair value of collateral has been determined and the impairment amount calculated, a specific reserve allocation is made. At June 30, 2010, $\$ 5,780,000$ of our Company s allowance for loan losses was allocated to impaired loans totaling approximately $\$ 63,062,000$. Based on detailed analysis of all impaired loans, management has determined that of approximately $\$ 63,062,000$ of impaired loans, $\$ 32,242,000$ require no reserve allocation due to excess collateral valuations.

As of June 30, 2010 and December 31, 2009 approximately $\$ 17,680,000$ and $\$ 15,944,000$, respectively, of loans not included in the table above have been classified by management as having more than normal risk which raised doubts as to the ability of the borrower to comply with present loan repayment terms. The $\$ 1,736,000$ increase in classified loans is the result of several borrowers who have experienced cash flow problems as well as some deterioration in collateral value. Management elected to allocate non-specific reserves to these credits based upon the inherent risk present. This increase in reserves was the result of our Company s internal loan review process which assesses credit risk.

The allowance for loan losses is available to absorb probable loan losses regardless of the category of loan to be charged off. The allowance for loan losses consists of asset-specific reserves, and reserves based on expected loss estimates and unallocated reserves.

The asset-specific component applies to loans evaluated individually for impairment and is based on management $s$ best estimate of proceeds from liquidating collateral. The actual timing and amount of repayments and the ultimate realizable value of the collateral may differ from management sestimate.

The expected loss component is generally determined by applying percentages to pools of loans by asset type. These percentages are determined by using a combination of average historical loss percentages and migration analysis. These expected loss estimates are sensitive to changes in delinquency status, realizable value of collateral, and other risk factors.

The unallocated portion of the allowance is based on management $s$ evaluation of conditions that are not directly reflected in the determination of the asset-specific component and the expected loss component discussed above. The evaluation of inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they may not be identified with specific problem credits or portfolio segments. Conditions evaluated in connection with the
unallocated portion of the allowance include general economic and business conditions affecting our key lending areas, credit quality trends (including trends in substandard loans expected to result from existing conditions), collateral values, specific industry conditions within portfolio segments, bank regulatory examination results, and findings of our internal loan review department.

The underlying assumptions, estimates and assessments used by management to determine these components are continually evaluated and updated to reflect management s current view of overall economic conditions and relevant factors impacting credit quality and inherent losses. Changes in such estimates could significantly impact the allowance and provision for credit losses. Our Company could experience credit losses that are different from the current estimates made by management.
The following table is a summary of the allocation of the allowance for loan losses as of the dates indicated:

|  | June 30, | December <br> 31, |  |
| :--- | ---: | ---: | ---: |
| (Dollars in thousands) | $\mathbf{2 0 1 0}$ | $\mathbf{2 0 0 9}$ |  |
| II |  |  |  |
| Allocation of allowance for loan losses at end of period: | $\$ 2,157$ | $\$$ | 2,773 |
| Commercial, financial, and agricultural | 1,074 | 348 |  |
| Real estate construction residential | 2,071 | 1,740 |  |
| Real estate construction commercial | 2,929 | 3,488 |  |
| Real estate mortgage residential | 3,083 | 4,693 |  |
| Real estate mortgage commercial | 247 | 380 |  |
| Installment loans to individuals | 671 | 1,375 |  |
| Unallocated | $\$ 12,232$ | $\$$ | 14,797 |

At June 30, 2010, management allocated $\$ 11,561,000$ of the $\$ 12,232,000$ total allowance for loan losses to specific loans and loan categories and $\$ 671,000$ was unallocated. At December 31, 2009, management allocated $\$ 13,422,000$ of the $\$ 14,497,000$ total allowance for loan losses to specific loans and loan categories and $\$ 1,375,000$ was unallocated. The decrease in the portion of the allowance for loan losses related to non asset-specific reserves is the result of management analyzing and assessing this portion of the allowance for loan losses on a more detailed level by homogeneous loan categories for loans not considered impaired. Such analysis measured reserve requirements based on historical loss experiences of loans in those individual categories and therefore provided a more robust reserve methodology. Such reserve methodology considers the loss experience for certain types of loans and loan grades for the past two years. Given the enhancements to the methodology for historical loss experience, the unallocated reserves for certain qualitative factors have been reduced accordingly. Management considers the non asset-specific portion of the allowance for loan losses at June 30, 2010 to be adequate as part of the over all reserves to cover losses in the loan portfolio not identified by specific loss methodologies.

Our Company does not lend funds for the type of transactions defined as highly leveraged by bank regulatory authorities or for foreign loans. Additionally, our Company does not have any concentrations of loans exceeding 10\% of total loans which are not otherwise disclosed in the loan portfolio composition table. Our Company does not have any interest-earning assets which would have been included in nonaccrual, past due, or restructured loans if such assets were loans.

## Financial Condition

Total assets increased $\$ 3,073,000$ or $0.3 \%$ to $\$ 1,239,543,000$ at June 30, 2010 compared to $\$ 1,236,470,000$ at December 31, 2009. Earning assets at June 30, 2010 were $\$ 1,157,253,000$ and consisted of $81.6 \%$ in loans and $14.5 \%$ in available for sale investment securities, compared to $85.9 \%$ and $13.3 \%$, respectively at December 31, 2009. Total liabilities increased $\$ 2,023,000$ or $0.2 \%$ to $\$ 1,130,723,000$ compared to $\$ 1,128,699,000$ at December 31, 2009. Stockholders equity increased $\$ 1,150,000$ or $1.1 \%$ to $\$ 108,921,000$ compared to $\$ 107,771,000$ at December 31, 2009.

As described in further detail in the Lending and Credit Management section above, during the first six months of 2010, total period end loans decreased $\$ 46,962,000$ to $\$ 944,652,000$ at June 30, 2010 compared to $\$ 991,614,000$ at December 31, 2009. This decrease was primarily the result of an $\$ 11,172,000$ decrease in commercial loans, an $\$ 11,106,000$ decrease in real estate residential loans, a $\$ 20,242,000$ decrease in real estate commercial loans, and a

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$\$ 2,265,000$ decrease in consumer loans.
Investment in debt securities classified as available-for-sale, excluding fair value adjustments, increased $\$ 13,166,000$ or $8.7 \%$ to $\$ 163,775,000$ at June 30, 2010 compared to $\$ 150,609,000$ at December 31, 2009. The net increase primarily consisted of an increase in mortgage-backed securities of $\$ 11,914,000$, an increase in federal agency securities of $\$ 7,150,000$, partially offset by a $\$ 6,897,000$ reduction in municipal obligations.

Total deposits increased $\$ 15,035,000$ or $1.6 \%$ to $\$ 971,358,000$ at June 30, 2010 compared to $\$ 956,323,000$ at December 31, 2009. The increase is primarily a result of an increase in public fund deposits.

Federal funds purchased and securities sold under agreements to repurchase decreased $\$ 1,476,000$ or $4.0 \%$ to $\$ 35,169,000$ at June 30, 2010 compared to $\$ 36,645,000$ at December 31, 2009. The decrease consisted of a $\$ 4,980,000$ decrease in federal funds purchased partially offset by a $\$ 3,503,000$ increase in repurchase agreements compared to December 31, 2009.

Other borrowed money decreased $\$ 11,967,000$ or $15.1 \%$ to $\$ 67,350,000$ at June 30,2010 compared to $\$ 79,317,000$ at December 31, 2009. The decrease reflects the repayment of Federal Home Loan Bank advances. There were no new Federal Home Loan Bank advances during the first six months of 2010.

Stockholders equity increased $\$ 1,049,000$ or $1.0 \%$ to $\$ 108,820,000$ at June 30,2010 compared to $\$ 107,771,000$ at December 31, 2009. The increase in stockholders equity reflects net income of $\$ 1,276,000$ less cash dividends declared of $\$ 1,445,000$, a $\$ 1,145,000$ change in unrealized holding gains, net of taxes, on investment in debt securities available-for-sale, $\$ 24,000$ amortization of prior service cost for defined benefit plan, and a $\$ 48,000$ increase, net of taxes, related to stock option compensation expense.
No material changes in our Company s liquidity or capital resources have occurred since June 30, 2010.

## Liquidity and Capital Resources

## Liquidity Management

The role of liquidity management is to ensure funds are available to meet depositors withdrawal and borrowers credit demands while at the same time maximizing profitability. This is accomplished by balancing changes in demand for funds with changes in the supply of those funds. Liquidity to meet the demands is provided by maturing assets, short-term liquid assets that can be converted to cash and the ability to attract funds from external sources, principally depositors. Due to the nature of services offered by our Company, management prefers to focus on transaction accounts and full service relationships with customers. Management believes it has the ability to increase deposits at any time by offering rates slightly higher than the market rate.

Our Company s Asset/Liability Committee (ALCO), primarily made up of senior management, has direct oversight responsibility for our Company s liquidity position and profile. A combination of daily, weekly and monthly reports provided to management detail the following: internal liquidity metrics, composition and level of the liquid asset portfolio, timing differences in short-term cash flow obligations, available pricing and market access to the financial markets for capital and exposure to contingent draws on our Company s liquidity.

Our Company has a number of sources of funds to meet liquidity needs on a daily basis. Our Company s most liquid assets are comprised of available for sale marketable investment securities, federal funds sold, and securities purchased under agreements to resell, and excess reserves held at the Federal Reserve as follows:

|  | December <br> $\mathbf{3 1 ,}$ <br> (dollars in thousands) <br> Liquid assets: | $\mathbf{2 0 1 0}$ |
| :--- | ---: | ---: |

Federal funds sold and resale agreements normally have overnight maturities and are used for general daily liquidity purposes. The fair value of the available for sale investment portfolio was $\$ 167,970,000$ at June 30, 2010 and included an unrealized net gain of $\$ 4,195,000$. The portfolio includes maturities of approximately $\$ 13,582,000$ over the next twelve months, which offer resources to meet either new loan demand or reductions in our Company s deposit base. Our Company pledges portions of its investment securities portfolio to secure public fund deposits, securities
sold under agreements to repurchase, trust funds, and borrowing capacity at the Federal Reserve Bank.

At June 30, 2010, total investment securities pledged for these purposes were as follows:

|  | June 30, |
| :--- | ---: |
| (dollars in thousands) | $\mathbf{2 0 1 0}$ |
| Investment securities pledged for the purpose of securing: | 3,303 |
| Federal Reserve Bank borrowings | 50,168 |
| Repurchase agreements | 101,182 |
| Other Deposits | $\$ 154,653$ |

At June 30, 2010, our Company s unpledged securities in the available for sale portfolio totaled approximately \$13,317,000.

Liquidity is also available from our Company s base of core customer deposits, defined as demand, interest, checking, savings, and money market deposit accounts. At June 30, 2010, such deposits totaled \$523,830,000 and represented $53.9 \%$ of our Company s total deposits. These core deposits are normally less volatile and are often tied to other products of our Company through long lasting relationships. Time deposits and certificates of deposit of $\$ 100,000$ and over totaled $\$ 447,528,000$ at June 30, 2010.

These accounts are normally considered more volatile and higher costing representing $46.1 \%$ of total deposits at June 30, 2010.

|  |  | December |  |
| :--- | ---: | ---: | ---: |
| (dollars in thousands) | June 30, | $\mathbf{3 1 ,}$ |  |
|  | $\mathbf{2 0 1 0}$ | $\mathbf{2 0 0 9}$ |  |
| Core deposit base: | $\$ 131,505$ | $\$$ | 135,018 |
| Non-interest bearing demand | 173,056 | 139,624 |  |
| Interest checking | 219,269 | 214,660 |  |
| Savings and money market | $\$ 523,830$ | $\$$ | 489,302 |

Other components of liquidity are the level of borrowings from third party sources and the availability of future credit. Our Company s outside borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, FHLB advances, and subordinated notes as follows:

|  | December <br> 31, |  |
| :--- | ---: | ---: |
| (dollars in thousands) | June 30, | $\mathbf{2 0 1 0}$ |

Federal funds purchased are overnight borrowings obtained mainly from upstream correspondent banks with which our Company maintains approved credit lines. As of June 30, 2010, under agreements with these unaffiliated banks, the Bank may borrow up to $\$ 35,911,000$ in federal funds on an unsecured basis and $\$ 8,862,000$ on a secured basis. There were no federal funds purchased outstanding at June 30, 2010. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of our Company s investment portfolio. At June 30, 2010 there was $\$ 32,098,000$ in repurchase agreements and $\$ 3,071,000$ in a term repurchase agreement due July 2010. Our Company may periodically borrow additional short-term funds from the Federal Reserve Bank through the discount window; although no such borrowings were outstanding at the current quarter end. The Bank is a member of the Federal Home Loan Bank of Des Moines (FHLB). As a member of the FHLB, the Bank has access to credit products of the FHLB. As of June 30, 2010, the Bank had $\$ 67,350,000$ in outstanding borrowings with the FHLB. In addition, our Company has $\$ 49,486,000$ in outstanding subordinated notes issued to wholly-owned grantor trusts, funded by preferred securities issued by the trusts.

Our Company pledges certain assets, including loans and investment securities to the Federal Reserve Bank, FHLB, and other correspondent banks as security to establish lines of credit and borrow from these entities. Based on
the type and value of collateral pledged, our Company may draw advances against this collateral. The following table reflects collateral value of assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to our Company at June 30, 2010:

|  | June 30, 2010 <br> Federal <br> Reserve |  |  |  |
| :--- | :---: | :---: | :---: | :---: |
| (dollars in thousands) | FHLB | Other |  |  |
| Collateral value pledged | $\$ 284,157$ | $\$$ | 3,303 | $\$ 7,518$ |
| Advances outstanding | $(67,350)$ |  |  |  |
| Total | $\$ 216,807$ | $\$$ | 3,303 | $\$ 7,518$ |

## Sources and Uses of Funds

Cash and cash equivalents were $\$ 56,028,000$ at June 30, 2010 compared to $\$ 24,666,000$ at December 31, 2009. The $\$ 31,362,000$ increase resulted from changes in the various cash flows produced by operating, investing, and financing activities of our Company, as shown in the accompanying consolidated statements of cash flows for the six months ended June 30, 2010. Cash flow provided from operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of $\$ 11,740,000$ during the first six months of 2010. Investing activities, consisting mainly of purchases, sales and maturities of available for sale securities, and changes in the level of the loan portfolio, provided cash of $\$ 19,734,000$. The cash outflow primarily consisted of purchases of $\$ 140,268,000$ of investment securities offset by a $\$ 27,992,000$ decrease in the loan portfolio, $\$ 126,818,000$ in proceeds from maturities, calls, and pay-downs of investment securities, and $\$ 4,802,000$ in proceeds from sales of other real estate owned and repossessions. Financing activities used total cash of $\$ 111,000$, resulting primarily from $\$ 11,968,000$ repayments of FHLB advances, $\$ 23,005,000$ decrease in demand and time deposits, $\$ 1,703,000$ decrease in dividends paid, and $\$ 1,476,000$ decrease in federal funds purchased and securities sold under agreements to repurchase, partially offset by a $\$ 38,040,000$ increase in interest-bearing transaction accounts. Future short-term liquidity needs arising from daily operations are not expected to vary significantly during 2010.

During 2008, liquidity risk became a concern affecting the general banking industry. Because of the uncertainty in the economy, our Company decided to participate in the U.S. Treasury Department s Capital Purchase Program (CPP), a voluntary program that provides capital to financially healthy banks. During 2009, our Company elected to cease market purchases of treasury stock and preserve its cash and capital position.

In the normal course of business, our Company enters into certain forms of off-balance sheet transactions, including unfunded loan commitments and letters of credit. These transactions are managed through our Company s various risk management processes. Management considers both on-balance sheet and off-balance sheet transactions in its evaluation of our Company s liquidity. Our Company had $\$ 120,872,000$ in unused loan commitments and standby letters of credit as of June 30, 2010. While this commitment level would be difficult to fund given our Company s current liquidity resources, we know that the nature of these commitments are such that the likelihood of such a funding demand is very low.

Our Company is a legal entity, separate and distinct from the Bank, which must provide its own liquidity to meet its operating needs. Our Company s ongoing liquidity needs primarily include funding its operating expenses and paying cash dividends to its common and preferred shareholders. During the six months ended June 30, 2010 and 2009, our Company paid cash dividends to its common and preferred shareholders totaling $\$ 1,703,000$ and $\$ 2,351,000$. A large portion of our Company s liquidity is obtained from the Bank in the form of dividends. For the first six months ended June 30, 2010, the Bank declared and paid dividends of \$1,200,000. At June 30, 2010 and December 31, 2009, our Company had cash and cash equivalents totaling $\$ 11,726,000$ and $\$ 14,738,000$ respectively. Regulatory Capital

Our Company and our Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly
additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on our Company s consolidated financial statements. Under capital adequacy guidelines, our Company and our Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification of our Company and our Bank are subject to qualitative judgments by the regulators about components, risk-weightings, and other factors.

Quantitative measures established by regulations to ensure capital adequacy require our Company and our Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital to risk-weighted assets, and of Tier I capital to adjusted-average assets. Management believes, as of June 30, 2010 and December 31, 2009, our Company and our Bank each meet all capital adequacy requirements to which they are subject.

The following table summarizes our Company s risk-based capital and leverage ratios at the dates indicated.

|  | Actual |  | Minimum Capital requirements |  | Well-Capitalized Capital Requirements |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2010 |  |  |  |  |  |  |
| Total capital (to |  |  |  |  |  |  |
| Company | \$ 165,663 | 17.07\% | \$ 77,640 | 8.00\% |  |  |
| Hawthorn Bank | 136,476 | 14.33 | 76,210 | 8.00 | \$ 95,263 | 10.00\% |
| Tier I capital (to risk-weighted assets): |  |  |  |  |  |  |
| Company | \$ 141,101 | 14.54 | \$ 38,820 | 4.00\% |  |  |
| Hawthorn Bank | 124,712 | 13.09 | 38,105 | 4.00 | \$ 57,158 | 6.00\% |
| Tier I capital (to adjusted average assets): |  |  |  |  |  |  |
| Company | \$ 141,101 | 11.31 | \$ 37,435 | 3.00\% |  |  |
| Hawthorn Bank | 124,712 | 10.17 | 36,781 | 3.00 | \$ 61,302 | 5.00\% |
|  | Actual |  | Minimum Capital requirements |  | Well-Capitalized Capital Requirements |  |
|  | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| December 31, 2009 |  |  |  |  |  |  |
| Total capital (to risk-weighted assets): |  |  |  |  |  |  |
| Company | \$ 165,969 | 16.49\% | \$ 80,502 | 8.00\% |  |  |
| Hawthorn Bank | 134,673 | 13.62 | 79,129 | 8.00 | \$ 98,911 | 10.00\% |
| Tier I capital (to risk-weighted assets): |  |  |  |  |  |  |
| Company | \$ 140,974 | 14.01 | \$ 40,251 | 4.00\% |  |  |
| Hawthorn Bank | 122,285 | 12.36 | 39,564 | 4.00 | \$ 59,347 | 6.00\% |
| Tier I capital (to adjusted average assets): |  |  |  |  |  |  |
| Company | \$ 140,974 | 11.35 | \$ 37,254 | 3.00\% |  |  |
| Hawthorn Bank | 122,285 | 10.04 | 36,556 | 3.00 | \$ 60,926 | 5.00\% |

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk arises from exposure to changes in interest rates and other relevant market rate or price risk. Our Company faces market risk in the form of interest rate risk through transactions other than trading activities. Our Company uses financial modeling techniques to measure interest rate risk. These techniques measure the sensitivity of future earnings due to changing interest rate environments. Guidelines established by our Company s Asset/Liability Committee and approved by the Board of Directors are used to monitor exposure of earnings at risk. General interest rate movements are used to develop sensitivity as our Company feels it has no primary exposure to specific points on the yield curve. For the period ended June 30, 2010, our Company utilized a 300 basis point immediate and gradual move in interest rates (both upward and downward) applied to both a parallel and proportional yield curve.

The following table represents estimated interest rate sensitivity and periodic and cumulative gap positions calculated as of June 30, 2010:

| (Dollars in thousands) |  | Year 1 |  | ear 2 |  | Year 3 | Year 4 | Year 5 | Over <br> 5 years or no stated Maturity |  | Total |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| ASSETS |  |  |  |  |  |  |  |  |  |  |  |
| Investment securities | \$ | 6,716 | \$ | 3,352 | \$ | 10,561 | \$ 22,538 | \$ 22,458 | \$ 102,345 | \$ | 167,970 |
| Interest-bearing deposits |  | 38,295 |  |  |  |  |  |  |  |  | 38,295 |
| Other restricted investments |  | 6,158 |  |  |  |  |  |  |  |  | 6,158 |
| Federal funds sold and securities purchased under agreements to |  |  |  |  |  |  |  |  |  |  |  |
| resell |  | 178 |  |  |  |  |  |  |  |  | 178 |
| Loans |  | 484,161 |  | 87,223 |  | 159,826 | 59,268 | 22,661 | 31,514 |  | 944,653 |
| Total |  | 535,508 |  | 90,575 |  | 170,387 | \$81,806 | \$45,119 | \$ 133,859 |  | ,157,254 |

## LIABILITIES

| Savings, Now deposits | \$ | \$ | \$ 165,331 | \$ | \$ | \$ | \$ | 165,331 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Rewards checking, |  |  |  |  |  |  |  |  |
| Super Now, money |  |  |  |  |  |  |  |  |
| market deposits <br> Time deposits | $\begin{aligned} & 227,330 \\ & 329,108 \end{aligned}$ | 64,969 | 22,032 | 26,734 | 4,349 |  |  | $\begin{array}{r} 227,330 \\ 447,192 \end{array}$ |
| Federal funds purchased and securities sold under agreements to |  |  |  |  |  |  |  |  |
| repurchase | 35,169 |  |  |  |  |  |  | 35,169 |
| Subordinated notes | 49,486 |  |  |  |  |  |  | 49,486 |
| Other borrowed money | 43,704 | 15,389 | 8,242 | 15 |  |  |  | 67,350 |
| Total | \$ 684,797 | \$ 80,358 | \$ 195,605 | \$26,749 | \$ 4,349 | \$ | \$ | 991,858 |

Interest-sensitivity GAP Periodic GAP

Cumulative GAP

Ratio of interest-earnings assets to interest-bearing liabilities

| Periodic GAP | 0.78 | 2.37 | 0.87 | 3.06 | 10.37 | NM | 1.17 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Cumulative GAP | 0.78 | 0.95 | 0.93 | 0.99 | 1.03 | 1.17 | 1.17 |

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## Item 4. Controls and Procedures

Our Company s management has evaluated, with the participation of our principal executive and principal financial officers, the effectiveness of our disclosure controls and procedures as defined in Rules 13a 15(e) or 15d 15(e) of the Securities Exchange Act of 1934 as of June 30, 2010. Based upon and as of the date of that evaluation, our principal executive and principal financial officers concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported as and when required. It should be noted that any system of disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any system of disclosure controls and procedures is based in part upon assumptions about the likelihood of future events. Because of these and other inherent limitations of any such system, there can be no assurance that any design will always succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

There has been no change in our Company s internal control over financial reporting that occurred during the fiscal quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## Impact of New Accounting Standards

In January 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-06 which amends ASC Topic 820, Fair Value Measurements and Disclosures. This update will provide more robust disclosures about (1) the different classes of assets and liabilities measured at fair value, (2) the valuation techniques and inputs used, (3) the activity in Level 3 fair value measurements, and (4) the transfers between Levels 1,2, and 3. This is effective for financial statements issued for interim and annual periods ending after December 15, 2009. The interim disclosures required by this update are reported in the notes to our Company s consolidated financial statements.

In February 2010, the FASB issued ASU No. 2010-10 which amends ASC Topic 810, Consolidation. The objective of this update is to defer the effective date of the amendments to the consolidation requirements made by FASB Statement 167 to a reporting entity s interest in certain types of entities and clarify other aspects of the Statement 167 amendments. As a result of the deferral, a reporting entity will not be required to apply the Statement 167 amendments to the Subtopic 810-10 consolidation requirements to its interest in an entity that meets the criteria to qualify for deferral. However, the amendments in this Update do not defer the disclosure requirements in the Statement 167 amendments to Topic 810. This is effective for financial statements issued for the first annual period beginning after November 15, 2009, and for interim periods with the first annual reporting period. The interim disclosures required by this new update did not have a material effect in the notes to our Company s consolidated financial statements.

In July 2010, the FASB issued ASU No. 2010-20 Receivables (ASC Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. This ASU requires expanded credit risk disclosures intended to provide investors with greater transparency regarding the allowance for credit losses and the credit quality of financing receivables. Under this ASU, companies will be required to provide more information about the credit quality of their financing receivables in the disclosures to financial statements, such as aging information, credit quality indicators, changes in the allowance for credit losses, and the nature and extent of troubled debt restructurings and their effect on the allowance for credit losses. Both new and existing disclosures must be disaggregated by portfolio segment or class based on the level of disaggregation that management uses when assessing its allowance for credit losses and managing its credit exposure. The disclosures as of the end of a reporting period will be effective for interim and annual periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period will be effective for interim and annual reporting periods beginning on or after December 15, 2010. Our Company is currently evaluating the disclosure requirements under this ASU and the impact on our consolidated financial statements and the disclosures presented in our consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events, which was incorporated into ASC Topic 855 Subsequent Events (ASC 855). ASC 855 provides guidance on management s assessment of subsequent events. The statement is not expected to significantly change practice because its guidance is similar to that in American Institute of Certified Public Accountants Professional Standards U.S. Auditing Standards Section 560, Subsequent Events, with

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some modifications. This statement became effective for our Company on June 15, 2009. The adoption of this statement did not have a material effect on our financial statements. In February 2010, the FASB issued ASU No. 2010-09 Subsequent Events Amendments to Certain Recognition and Disclosure Requirements, which removed the requirements in ASC 855 for an SEC filer to disclose the date through which subsequent events
have been evaluated for both issued and revised financial statements. This update became effective upon issuance for our Company and the adoption of this update did not have a material effect on our financial statements

In June 2009, the FASB issued authoritative guidance on accounting for transfers of financial assets, which was subsequently incorporated into ASC Topic 860, Transfers and Servicing. The new guidance amends ASC Topic 860 and requires more information about transfers of financial assets, including securitization transactions, and where companies have continuing exposure to the risks related to transferred financial assets. The guidance eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets and requires additional disclosures. This became effective for the first annual period beginning after November 15, 2009, and for interim periods within the first annual reporting period, and must be applied to transfers occurring on or after the effective date. Our Company follows the requirements of the new guidance, which did not significantly impact our consolidated financial statements or the disclosures presented in our consolidated financial statements.

## PART II OTHER INFORMATION

| Item 1. | Legal Proceedings | None |
| :---: | :---: | :---: |
| Item 1A. | Risk Factors | None |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | None |
| Item 3. | Defaults Upon Senior Securities | None |
| Item 4. | (Removed and Reserved) | None |
| Item 5. | Other Information | None |
| Item 6. | Exhibits |  |
| Exhibit No 3.1 | Description <br> Restated Articles of Incorporation of our Company (filed as Exhibit 3.1 to our Company on Form 8-K on August 9, 2007 and incorporated herein by reference). | rrent report |
| 3.1.1 | Certificate of Designations of Fixed Rate Cumulative Perpetual Preferred Stock, Series 2008 December 17, 2008 (filed as Exhibit 3.1.1 to our Company s current report on Form 8-K December 23, 2008 and incorporated herein by reference). | dated |
| 3.2 | Amended and Restated Bylaws of our Company (filed as Exhibit 3.1 to our Company scur Form 8-K on June 8, 2009 and incorporated herein by reference). | ent report on |
| 4.1 | Specimen certificate representing shares of our Company s $\$ 1.00$ par value common stock Exhibit 4.1 to our Company s Annual Report on Form 10-K for the fiscal year ended De (Commission file number 0-23636) and incorporated herein by reference). | (filed as mber 31, 1999 |
| 4.2 | Specimen certificate representing shares of our Fixed Rate Cumulative Perpetual Preferre Series 2008 (filed as Exhibit 4.2 to our Company s current report on Form 8-K on Decem and incorporated herein by reference). | Stock, $\text { er } 23,2008$ |
| 4.3 | Warrant to purchase shares of our Company s $\$ 1.00$ par value Common Stock, dated Dece 2008 (filed as Exhibit 4.3 to our Company s current report on Form 8-K on December 23, incorporated herein by reference). | mber 19, 2008 and |
| 31.1 | Certificate of the Chief Executive Officer of our Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |  |
| 31.2 | Certificate of the Chief Financial Officer of our Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |  |
| 32.1 | Certificate of the Chief Executive Officer of our Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |  |

Certificate of the Chief Financial Officer of our Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

## SIGNATURES

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

## HAWTHORN BANCSHARES, INC.

## Date

August 13, 2010

August 13, 2010

/s/ James E. Smith<br>James E. Smith, Chairman of the Board and Chief Executive Officer Principal Executive Officer)<br>/s/ Richard G. Rose<br>Richard G. Rose, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)

## HAWTHORN BANCSHARES. INC. <br> INDEX TO EXHIBITS <br> June 30, 2010 Form 10-Q

| Exhibi | Description | Page No. |
| :---: | :---: | :---: |
| 3.1 | Restated Articles of Incorporation of our Company (filed as Exhibit 3.1 to our Company s current report on Form 8-K on August 9, 2007 and incorporated herein by reference). | ** |
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| ** Incorpo reference | ated by <br> e. |  |

