

HAWTHORN BANCSHARES, INC.  
Form 10-Q  
November 14, 2011

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended September 30, 2011

or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from            to

Commission File Number: 0-23636

**HAWTHORN BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

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

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

**300 Southwest Longview Boulevard,**  
**Lee s Summit, Missouri**  
(Address of principal executive offices)

**64081**  
(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.  Yes  No

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

As of November 14, 2011 the registrant had 4,652,994 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)

## Consolidated Balance Sheets

	September 30, 2011	December 31, 2010
<b>ASSETS</b>		
Loans	\$ 849,801,000	\$ 898,472,463
Allowances for loan losses	(12,690,578)	(14,564,867)
<b>Net loans</b>	837,110,422	883,907,596
Investment in available-for-sale securities, at fair value	205,446,454	178,977,550
Federal funds sold and securities purchased under agreements to resell	75,000	125,815
Cash and due from banks	41,306,401	50,853,985
Premises and equipment - net	37,928,543	36,980,503
Other real estate owned and repossessed assets - net	18,066,847	14,009,017
Accrued interest receivable	5,383,405	5,733,684
Mortgage servicing rights	2,266,109	2,355,990
Intangible assets - net	646,771	977,509
Cash surrender value - life insurance	2,045,673	2,001,965
Other assets	19,240,422	24,248,590
<b>Total assets</b>	\$ 1,169,516,047	\$ 1,200,172,204
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Deposits:		
Non-interest bearing demand	\$ 157,183,939	\$ 137,749,571
Savings, interest checking and money market	375,645,240	379,137,539
Time deposits \$100,000 and over	136,619,758	124,566,760
Other time deposits	283,500,197	305,208,786
<b>Total deposits</b>	952,949,134	946,662,656
Federal funds purchased and securities sold under agreements to repurchase	26,196,899	30,068,453
Subordinated notes	49,486,000	49,486,000
Federal Home Loan Bank advances	28,491,572	66,985,978
Accrued interest payable	850,188	1,491,503
Other liabilities	5,266,572	3,989,303
<b>Total liabilities</b>	1,063,240,365	1,098,683,893
Stockholders equity:		
Preferred stock, \$1,000 par value Authorized and issued 30,255 shares	29,198,598	28,841,242
Common stock, \$1 par value Authorized 15,000,000 shares; issued 4,814,852, and 4,635,891 shares, respectively	4,814,852	4,635,891
Surplus	30,254,277	28,928,545
Retained earnings	42,104,547	41,857,302
Accumulated other comprehensive income, net of tax	3,420,226	742,149
Treasury stock; 161,858 shares, at cost	(3,516,818)	(3,516,818)

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<b>Total stockholders' equity</b>	106,275,682	101,488,311
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,169,516,047</b>	<b>\$ 1,200,172,204</b>

See accompanying notes to the consolidated financial statements (*unaudited*).

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

## Consolidated Statements of Operations

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ 11,851,708	\$ 13,234,729	\$ 35,930,550	\$ 40,286,802
Interest on debt securities:				
Taxable	1,236,984	1,054,667	3,734,838	3,236,744
Nontaxable	250,569	273,538	780,470	894,293
Interest on federal funds sold and securities purchased under agreements to resell	14	50	76	133
Interest on interest-bearing deposits	7,868	27,851	40,156	63,373
Dividends on other securities	36,788	33,577	121,149	119,024
<b>Total interest income</b>	<b>13,383,931</b>	<b>14,624,412</b>	<b>40,607,239</b>	<b>44,600,369</b>
<b>INTEREST EXPENSE</b>				
Interest on deposits:				
Savings, interest checking and money market	387,074	511,442	1,318,578	1,696,648
Time deposit accounts \$100,000 and over	402,246	594,334	1,298,067	1,956,968
Other time deposit accounts	1,243,989	1,758,850	3,982,778	5,607,583
Interest on federal funds purchased and securities sold under agreements to repurchase	12,518	19,690	38,501	59,353
Interest on subordinated notes	321,453	353,536	964,420	1,201,082
Interest on Federal Home Loan Bank advances	212,423	527,818	937,600	1,794,832
<b>Total interest expense</b>	<b>2,579,703</b>	<b>3,765,670</b>	<b>8,539,944</b>	<b>12,316,466</b>
<b>Net interest income</b>	<b>10,804,228</b>	<b>10,858,742</b>	<b>32,067,295</b>	<b>32,283,903</b>
Provision for loan losses	2,010,000	2,450,000	5,643,336	7,105,000
<b>Net interest income after provision for loan losses</b>	<b>8,794,228</b>	<b>8,408,742</b>	<b>26,423,959</b>	<b>25,178,903</b>
<b>NON-INTEREST INCOME</b>				
Service charges on deposit accounts	1,446,224	1,427,130	4,175,987	4,150,420
Trust department income	208,772	186,989	632,638	566,495
Gain on sale of mortgage loans, net	431,503	1,011,253	893,733	1,533,027
Other	270,916	284,932	885,761	1,115,838
<b>Total non-interest income</b>	<b>2,357,415</b>	<b>2,910,304</b>	<b>6,588,119</b>	<b>7,365,780</b>
<b>NON-INTEREST EXPENSE</b>				
Salaries and employee benefits	4,504,853	4,256,523	13,515,546	13,463,964
Occupancy expense, net	734,739	654,687	1,957,788	1,881,093
Furniture and equipment expense	467,479	472,657	1,483,262	1,499,307
FDIC insurance assessment	254,595	442,965	1,129,608	1,288,163
Legal, examination, and professional fees	285,834	348,792	1,083,443	932,115
Advertising and promotion	271,896	311,219	773,771	886,242
Postage, printing, and supplies	271,245	299,997	835,726	874,353
Processing expense	787,132	853,710	2,422,017	2,560,570
Other real estate expense	523,592	882,264	1,564,461	2,895,010
Other	823,745	842,703	2,545,337	2,535,084

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<b>Total non- interest expense</b>	8,925,110	9,365,517	27,310,959	28,815,901
Income before income taxes	2,226,533	1,953,529	5,701,119	3,728,782
Income tax expense	710,894	531,327	1,823,369	1,030,346
<b>Net income</b>	1,515,639	1,422,202	3,877,750	2,698,436
Preferred stock dividends	378,187	378,187	1,130,360	1,130,360
Accretion of discount on preferred stock	119,119	119,119	357,356	357,356
<b>Net income available to common shareholders</b>	\$ 1,018,333	\$ 924,896	\$ 2,390,034	\$ 1,210,720
Basic earnings per share	\$ 0.22	\$ 0.20	\$ 0.51	\$ 0.26
Diluted earnings per share	\$ 0.22	\$ 0.20	\$ 0.51	\$ 0.26

See accompanying notes to the consolidated financial statements (*unaudited*).

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

## Consolidated Statements of Stockholders' Equity and Comprehensive Income

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stock - holders Equity
<b>Balance, December 31, 2009</b>	\$ 28,364,768	\$ 4,463,813	\$ 26,970,745	\$ 50,576,551	\$ 912,224	\$ (3,516,818)	\$ 107,771,283
Net income				2,698,436			2,698,436
Change in unrealized gain (loss) on securities:							
Unrealized gain on debt securities available-for-sale, net of tax					1,394,275		1,394,275
Defined benefit pension plans:							
Amortization of prior service cost included in net periodic pension cost, net of tax					35,973		35,973
Total other comprehensive income							1,430,248
Total comprehensive income							4,128,684
Stock based compensation expense			68,009				68,009
Accretion of preferred stock discount	357,356			(357,356)			
Stock dividend		172,078	1,870,490	(2,042,568)			
Cash dividends declared, preferred stock				(1,134,562)			(1,134,562)
Cash dividends declared, common stock				(912,015)			(912,015)
<b>Balance, September 30, 2010</b>	<b>\$ 28,722,124</b>	<b>\$ 4,635,891</b>	<b>\$ 28,909,244</b>	<b>\$ 48,828,486</b>	<b>\$ 2,342,472</b>	<b>\$ (3,516,818)</b>	<b>\$ 109,921,399</b>
<b>Balance, December 31, 2010</b>	<b>\$ 28,841,242</b>	<b>\$ 4,635,891</b>	<b>\$ 28,928,545</b>	<b>\$ 41,857,302</b>	<b>\$ 742,149</b>	<b>\$ (3,516,818)</b>	<b>\$ 101,488,311</b>
Net income				3,877,750			3,877,750
Change in unrealized gain on securities:							
Unrealized gain on debt securities available-for-sale, net of tax					2,642,104		2,642,104

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Defined benefit pension plans:							
Amortization of prior service cost included in net periodic pension cost, net of tax					35,973		35,973
Total other comprehensive income							2,678,077
Total comprehensive income							6,555,827
Stock based compensation expense			46,159				46,159
Accretion of preferred stock discount	357,356				(357,356)		
Stock dividend		178,961	1,279,573		(1,458,534)		
Cash dividends declared, preferred stock					(1,134,562)		(1,134,562)
Cash dividends declared, common stock					(680,053)		(680,053)
<b>Balance, September 30, 2011</b>	<b>\$ 29,198,598</b>	<b>\$ 4,814,852</b>	<b>\$ 30,254,277</b>	<b>\$ 42,104,547</b>	<b>\$ 3,420,226</b>	<b>\$ (3,516,818)</b>	<b>\$ 106,275,682</b>

See accompanying notes to the consolidated financial statements (unaudited).



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

## Consolidated Statements of Cash Flows

	<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 3,877,750	\$ 2,698,436
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	5,643,336	7,105,000
Depreciation expense	1,442,991	1,484,686
Net amortization of debt securities, premiums, and discounts	619,756	454,671
Amortization of core deposit intangible assets	330,738	408,451
Stock based compensation expense	46,159	68,009
(Gain) loss on sales and dispositions of premises and equipment	(12,633)	59,621
Loss on sales and dispositions of other real estate owned and repossessions	218,920	1,958,537
Provision for other real estate owned	660,968	
Decrease in accrued interest receivable	350,279	605,146
Increase in cash surrender value -life insurance	(43,708)	(49,556)
Decrease in income tax receivable	1,328,205	
Decrease in other assets	309,624	578,938
Decrease in accrued interest payable	(641,315)	(1,093,420)
Increase in other liabilities	1,268,322	871,960
Origination of mortgage loans for sale	(44,356,425)	(72,437,349)
Proceeds from the sale of mortgage loans	43,784,779	69,193,376
Gain on sale of mortgage loans, net	(893,733)	(1,533,027)
Decrease in net deferred tax asset	22,998	728,912
Other, net	35,973	35,973
<b>Net cash provided by operating activities</b>	<b>13,992,984</b>	<b>11,138,364</b>
<b>Cash flows from investing activities:</b>		
Net decrease in loans	32,623,605	42,321,380
Purchase of available-for-sale debt securities	(93,071,486)	(154,204,703)
Proceeds from maturities of available-for-sale debt securities	26,129,495	105,724,703
Proceeds from calls of available-for-sale debt securities	44,184,650	38,065,100
Proceeds from sales of FHLB stock	1,753,000	995,600
Purchases of premises and equipment	(2,430,940)	(320,967)
Proceeds from sales of premises and equipment	47,549	34,528
Proceeds from sales of other real estate owned and repossessions	5,057,894	9,185,427
<b>Net cash provided in investing activities</b>	<b>14,293,767</b>	<b>41,801,068</b>
<b>Cash flows from financing activities:</b>		
Net increase in demand deposits	19,434,368	8,125,557
Net (decrease) increase in interest-bearing transaction accounts	(3,492,299)	9,632,603
Net decrease in time deposits	(9,655,591)	(23,507,003)
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(3,871,554)	(5,185,424)
Proceeds from Federal Home Loan Bank advances		10,000,000
Repayment of Federal Home Loan Bank advances	(38,494,406)	(22,149,255)
Cash dividends paid - preferred stock	(1,134,562)	(1,134,562)
Cash dividends paid - common stock	(671,106)	(1,161,528)
<b>Net cash used by financing activities</b>	<b>(37,885,150)</b>	<b>(25,379,612)</b>
Net (decrease) increase in cash and cash equivalents	(9,598,399)	27,559,820

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Cash and cash equivalents, beginning of period	50,979,800	24,665,695
<b>Cash and cash equivalents, end of period</b>	<b>\$ 41,381,401</b>	<b>\$ 52,225,515</b>

See accompanying notes to the consolidated financial statements (unaudited).

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

## Consolidated Statements of Cash Flows

	<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 9,181,259	\$ 13,409,886
Income taxes	\$ 665,000	\$ 200,000
<b>Supplemental schedule of noncash investing and financing activities:</b>		
Other real estate and repossessions acquired in settlement of loans	\$ 9,995,612	\$ 12,665,463

See accompanying notes to the consolidated financial statements (unaudited).

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

**(1) Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q, do not include all of the information and disclosures required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes filed in our Company's Annual Report on Form 10-K for the year ended December 31, 2010.

The accompanying unaudited consolidated financial statements include all adjustments that, in the opinion of management, are necessary in order to make those statements not misleading. Management is required to make estimates and assumptions, including the determination of the allowance for loan losses, real estate acquired in connection with foreclosure or in satisfaction of loans, and fair values of investment 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. Actual results could differ from those estimates. Our Company's management has evaluated and did not identify any subsequent events or transactions requiring recognition or disclosure in the consolidated financial statements.

On July 1, 2011, our Company paid a special stock dividend of four percent to common shareholders of record at the close of business on May 12, 2011. For all periods presented, share information, including basic and diluted earnings per share have been adjusted retroactively to reflect this change.

The significant accounting policies followed in the preparation of the quarterly financial statements are disclosed in the 2010 Annual Report on form 10-K.

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

Notes to the Consolidated Financial Statements

*(Unaudited)***(2) Loans and Allowance for Loan Losses**

A summary of loans, by major class within our Company's loan portfolio, at September 30, 2011 and December 31, 2010 are as follows:

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Commercial, financial, and agricultural	\$ 126,065,400	\$ 131,382,467
Real estate construction - residential	29,129,725	31,834,174
Real estate construction - commercial	46,039,024	56,052,910
Real estate mortgage - residential	204,666,555	207,834,488
Real estate mortgage - commercial	413,682,553	439,068,622
Installment and other consumer	30,038,205	32,132,336
Unamortized loan origination fees and costs, net	179,538	167,466
<b>Total loans</b>	<b>\$ 849,801,000</b>	<b>\$ 898,472,463</b>

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the communities of and surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee's Summit, Missouri. As such, the Bank is susceptible to changes in the economic environment in these communities. The Bank does not have a concentration of credit in any one economic sector. Installment and other consumer loans consist primarily of the financing of vehicles.

At September 30, 2011, loans with a carrying value of \$440,525,000 were pledged at the Federal Home Loan Bank as collateral for borrowings and letters of credit.

*Allowance for loan losses*

The following table provides the balance in the allowance for loan losses at September 30, 2011 and December 31, 2010, and the related loan balance by impairment methodology. Loans evaluated under ASC 310-10-35 include loans on non-accrual status, which are individually evaluated for impairment, troubled debt restructurings, and other impaired loans deemed to have similar risk characteristics. All other loans are collectively evaluated for impairment under ASC 450-20. Although the allowance for loan losses is comprised of specific and general allocations, the entire allowance is available to absorb credit losses.

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

The following is a summary of the allowance for loan losses at or for the three and nine months ended September 30, 2011 as follows:

(in thousands)	For the Three Months Ended September 30, 2011							Unallocated	Total
	Commercial, Financial, and Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals			
<b>Allowance for loan losses:</b>									
<b>Balance, beginning of period</b>	\$ 2,533	\$ 986	\$ 1,330	\$ 2,990	\$ 4,837	\$ 219	\$ 968	\$ 13,863	
<b>Additions:</b>									
Provision for loan losses	562	284	490	(9)	1,550	99	(966)	2,010	
<b>Deductions:</b>									
Loans charged off	1,273	311	512	219	884	122		3,321	
Less recoveries on loans		(2)		(27)	(40)	(69)		(138)	
<b>Net loans charged off</b>	1,273	309	512	192	844	53		3,183	
<b>Balance, end of period</b>	\$ 1,822	\$ 961	\$ 1,308	\$ 2,789	\$ 5,543	\$ 265	\$ 2	\$ 12,690	
	For the Nine Months Ended September 30, 2011								
(in thousands)	Commercial, Financial, and Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Unallocated	Total	
<b>Allowance for loan losses:</b>									
<b>Balance, beginning of period</b>	\$ 2,931	\$ 2,067	\$ 1,339	\$ 3,922	\$ 3,458	\$ 231	\$ 617	\$ 14,565	
<b>Additions:</b>									
Provision for loan losses	968	688	231	524	3,641	206	(615)	5,643	
<b>Deductions:</b>									
Loans charged off	2,146	1,858	512	1,758	1,625	369		8,268	
Less recoveries on loans	(69)	(64)	(250)	(101)	(69)	(197)		(750)	
<b>Net loans charged off</b>	2,077	1,794	262	1,657	1,556	172		7,518	
<b>Balance, end of period</b>	\$ 1,822	\$ 961	\$ 1,308	\$ 2,789	\$ 5,543	\$ 265	\$ 2	\$ 12,690	



## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

The tables provide other information regarding the allowance for loan losses and balance by type of allowance methodology at September 30, 2011 and December 31, 2010 as follows:

<i>(in thousands)</i>	Commercial, Financial, and Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Unallocated	Total
<b>September 30, 2011</b>								
<b>Allowance for loan losses:</b>								
Individually evaluated for impairment	\$ 242	\$	\$ 85	\$ 334	\$ 3,272	\$	\$	\$ 3,933
Collectively evaluated for impairment	1,580	961	1,223	2,455	2,271	265	2	8,757
<b>Total</b>	<b>\$ 1,822</b>	<b>\$ 961</b>	<b>\$ 1,308</b>	<b>\$ 2,789</b>	<b>\$ 5,543</b>	<b>\$ 265</b>	<b>\$ 2</b>	<b>\$ 12,690</b>
<b>Loans outstanding:</b>								
Individually evaluated for impairment	\$ 3,966	\$ 650	\$ 7,232	\$ 6,316	\$ 35,351	\$	\$	\$ 53,515
Collectively evaluated for impairment	122,099	28,480	38,807	198,350	378,332	30,218		796,286
<b>Total</b>	<b>\$ 126,065</b>	<b>\$ 29,130</b>	<b>\$ 46,039</b>	<b>\$ 204,666</b>	<b>\$ 413,683</b>	<b>\$ 30,218</b>	<b>\$</b>	<b>\$ 849,801</b>
<b>December 31, 2010</b>								
<b>Allowance for loan losses:</b>								
Individually evaluated for impairment	\$ 1,737	\$ 1,553	\$ 201	\$ 1,117	\$ 1,768	\$	\$	\$ 6,376
Collectively evaluated for impairment	1,194	514	1,138	2,805	1,690	231	617	8,189
<b>Total</b>	<b>\$ 2,931</b>	<b>\$ 2,067</b>	<b>\$ 1,339</b>	<b>\$ 3,922</b>	<b>\$ 3,458</b>	<b>\$ 231</b>	<b>\$ 617</b>	<b>\$ 14,565</b>
<b>Loans outstanding:</b>								
Individually evaluated for impairment	\$ 3,660	\$ 3,586	\$ 11,783	\$ 8,040	\$ 29,076	\$	\$	\$ 56,145
Collectively evaluated for impairment	127,722	28,248	44,270	199,795	409,993	32,299		842,327
<b>Total</b>	<b>\$ 131,382</b>	<b>\$ 31,834</b>	<b>\$ 56,053</b>	<b>\$ 207,835</b>	<b>\$ 439,069</b>	<b>\$ 32,299</b>	<b>\$</b>	<b>\$ 898,472</b>

Loans, or portions of loans, are charged off to the extent deemed uncollectible. Loan charge-offs reduce the allowance for loan losses, and recoveries of loans previously charged off are added back to the allowance. Once the fair value for a collateral dependent loan has been determined, any impaired amount is typically charged off unless the loan has other income streams to support repayment. For impaired loans which have other income streams to support repayment, a specific reserve is established for the amount determined to be impaired.



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*Impaired loans*

Impaired loans totaled \$53,683,301 and \$56,270,543 at September 30, 2011 and December 31, 2010 respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings.

The categories of impaired loans at September 30, 2011 and December 31, 2010 are as follows:

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Non-accrual loans	\$ 46,661,244	\$ 50,586,887
Troubled debt restructurings continuing to accrue interest	7,022,057	5,683,656
<b>Total impaired loans</b>	<b>\$ 53,683,301</b>	<b>\$ 56,270,543</b>

At September 30, 2011, loans classified as troubled debt restructurings (TDRs) totaled \$33,694,501, of which \$26,672,444 were on non-accrual status and \$7,022,057 were on accrual status. At December 31, 2010, loans classified as TDRs totaled \$22,080,431, of which \$16,396,775 were on non-accrual status and \$5,683,656 was on accrual status. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at

## HAWTHORN BANCSHARES, INC.

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the loan's effective interest rate or the fair value of the underlying collateral less applicable selling costs. Accordingly, specific reserves of \$2,281,000 and \$1,359,000 were allocated to the allowance for loan losses at September 30, 2011 and December 31, 2010, respectively. As a result of adopting the amendments in Accounting Standards Update (ASU) No. 2011-02 *Receivables (ASC Topic 310) A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, our Company reassessed all restructurings that occurred on or after January 1, 2011 for identification as TDRs.

The following table summarizes loans that were modified as TDRs during the three and nine months ended September 30, 2011:

	Three Months Ended September 30, 2011			Nine Months Ended September 30, 2011		
	Number of Contracts	Pre- Modification	Post- Modification	Number of Contracts	Pre- Modification	Post- Modification
<b>Troubled Debt Restructurings</b>						
Commercial, financial and agricultural	1	\$ 1,196,080	\$ 1,196,080	8	\$ 3,200,191	\$ 3,199,086
Real estate construction - commercial	5	5,934,672	5,547,861	5	5,934,672	5,547,861
Real estate mortgage- residential	1	202,185	202,185	5	954,603	933,304
Real estate mortgage - commercial	7	5,412,927	5,146,928	9	7,539,214	7,273,215
<b>Total</b>	14	\$ 12,745,864	\$ 12,093,054	27	\$ 17,628,680	\$ 16,953,466

(1) The amounts reported post-modification are inclusive of all partial pay-downs and charge-offs, and no portion of the debt was forgiven.

Loans modified as a TDR that were fully paid down, charged-off or foreclosed upon during the period ended are not reported. According to guidance provided in ASC subtopic 310-40, *Troubled Debt Restructurings by Creditors*, a loan restructuring or modification of terms is a TDR if the creditor for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. Our Company's portfolio of loans classified as TDRs include concessions such as interest rates below the current market rate, deferring principal payments, and extending maturity dates. Once a loan becomes a TDR, it will continue to be reported as a TDR until it is ultimately repaid in full, charged-off, or foreclosed and sold. Our Company considers a loan in TDR status in default when the borrower's payment according to the modified terms is at least 90 days past due or has defaulted due to expiration of the loan's maturity date. During the nine months ended September 30, 2011, twenty-seven loans were modified meeting the criteria for troubled debt restructurings. During this time period none of these twenty-seven 2011 TDRs have subsequently defaulted.

Interest income recognized on loans in non-accrual status and contractual interest that would be recorded had the loans performed in accordance with their original contractual terms is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Contractual interest due on non-accrual loans	\$ 572,643	\$ 606,927	\$ 1,791,551	\$ 1,885,164
Interest income recognized on loans in non-accrual status	7,705	6,513	40,545	10,733

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<b>Net reduction in interest income</b>	\$ 564,938	\$ 600,414	\$ 1,751,006	\$ 1,874,431
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The specific reserve component of our Company's allowance for loan losses at September 30, 2011 and December 31, 2010 was determined by using fair values of the underlying collateral obtained through independent appraisals and internal evaluations, or by discounting the total expected future cash flows. The recorded investment varies from the unpaid principal balance primarily due to partial charge-offs taken resulting from current appraisals received. The amount recognized as interest income on impaired loans continuing to accrue interest, primarily related to troubled debt restructurings, was \$149,981 and \$480,950 for the nine months ended September 30, 2011 and September 30, 2010, respectively. Average recorded investment in impaired loans is calculated on a monthly basis during the period.

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The following table provides additional information about impaired loans at September 30, 2011 and December 31, 2010, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized For the Period Ended	
					Three Months	Nine Months
<b>At September 30, 2011</b>						
<b>With no related allowance recorded:</b>						
Commercial, financial and Agricultural	\$ 3,006,014	\$ 3,060,554	\$	\$ 3,516,582	\$ 29,671	\$ 18,597
Real estate - construction residential	649,985	844,642		1,488,000		
Real estate - construction commercial	7,046,795	7,360,078		9,818,048		
Real estate - residential	2,455,915	2,765,299		3,630,896	18,916	7,218
Real estate - commercial	14,181,853	15,584,303		11,844,195	41,287	23,247
Consumer	167,752	189,955		194,996	2,948	1,599
<b>Total</b>	<b>\$ 27,508,314</b>	<b>\$ 29,804,831</b>	<b>\$</b>	<b>\$ 30,492,717</b>	<b>\$ 92,822</b>	<b>\$ 50,661</b>
<b>With an allowance recorded:</b>						
Commercial, financial and Agricultural	\$ 960,623	\$ 849,256	\$ 242,308	\$ 660,959	\$ 9,843	\$ 5,443
Real estate - construction residential						
Real estate - construction commercial	185,154	188,278	85,000	82,846		
Real estate - residential	3,860,337	3,749,523	333,907	3,286,520	82,807	28,335
Real estate - commercial	21,168,873	21,897,239	3,272,050	17,685,872	5,054	1,765
<b>Total</b>	<b>\$ 26,174,987</b>	<b>\$ 26,684,296</b>	<b>\$ 3,933,265</b>	<b>\$ 21,716,197</b>	<b>\$ 97,704</b>	<b>\$ 35,543</b>
<b>Total impaired loans</b>	<b>\$ 53,683,301</b>	<b>\$ 56,489,127</b>	<b>\$ 3,933,265</b>	<b>\$ 52,208,914</b>	<b>\$ 190,526</b>	<b>\$ 86,204</b>
<b>At December 31, 2010</b>						
<b>With no related allowance recorded:</b>						
Commercial, financial and Agricultural	\$ 441,861	\$ 629,296	\$			
Real estate - construction residential	1,769,622	2,355,936				
Real estate - construction commercial	8,297,388	9,393,368				
Real estate - residential	2,463,735	2,950,560				
Real estate - commercial	12,939,973	14,869,833				
Consumer	125,858	132,688				
<b>Total</b>	<b>\$ 26,038,437</b>	<b>\$ 30,331,681</b>	<b>\$</b>			
<b>With an allowance recorded:</b>						
Commercial, financial and Agricultural	\$ 3,217,995	\$ 3,260,009	\$ 1,737,159			
Real estate - construction residential	1,816,276	1,848,593	1,552,406			
Real estate - construction commercial	3,485,517	4,740,517	201,147			
Real estate - residential	5,576,292	5,669,041	1,117,141			

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Real estate - commercial	16,136,025	16,215,862	1,767,893
<b>Total</b>	<b>\$ 30,232,106</b>	<b>\$ 31,734,022</b>	<b>\$ 6,375,746</b>
<b>Total impaired loans</b>	<b>\$ 56,270,543</b>	<b>\$ 62,065,703</b>	<b>\$ 6,375,746</b>

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

(Unaudited)

It is our Company's policy to discontinue the accrual of interest income on loans when management believes that the borrower's financial condition, after consideration of business conditions and collection efforts, is such that the collection of interest is doubtful, or upon which principal or interest has been in default for a period of 90 days or more and the asset is not both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectability of such principal; otherwise, such receipts are recorded as interest income on a cash basis.

## Age Analysis of Past Due and Non-Accrual Loans

	Current or Less Than 30 Days Past Due	30 - 89 Days Past Due	90 Days Past Due And Still Accruing	Non-Accrual	Total
<b>September 30, 2011</b>					
Commercial, Financial, and Agricultural	\$ 123,612,428	\$ 544,765	\$ 3,230	\$ 1,904,977	\$ 126,065,400
Real Estate Construction - Residential	28,479,740			649,985	29,129,725
Real Estate Construction - Commercial	38,256,216	550,860		7,231,948	46,039,024
Real Estate Mortgage - Residential	199,396,369	1,389,622	23,076	3,857,488	204,666,555
Real Estate Mortgage - Commercial	379,754,317	936,979	142,163	32,849,094	413,682,553
Installment and Other Consumer	29,736,706	304,500	8,785	167,752	30,217,743
<b>Total</b>	<b>\$ 799,235,776</b>	<b>\$ 3,726,726</b>	<b>\$ 177,254</b>	<b>\$ 46,661,244</b>	<b>\$ 849,801,000</b>
<b>December 31, 2010</b>					
Commercial, Financial, and Agricultural	\$ 127,315,586	\$ 534,865	\$	\$ 3,532,016	\$ 131,382,467
Real Estate Construction - Residential	28,200,876	47,400		3,585,898	31,834,174
Real Estate Construction - Commercial	45,511,088	474,934		10,066,888	56,052,910
Real Estate Mortgage - Residential	199,386,784	2,775,654		5,672,050	207,834,488
Real Estate Mortgage - Commercial	409,906,845	1,557,599		27,604,178	439,068,622
Installment and Other Consumer	31,784,217	356,812	32,916	125,857	32,299,802
<b>Total</b>	<b>\$ 842,105,396</b>	<b>\$ 5,747,264</b>	<b>\$ 32,916</b>	<b>\$ 50,586,887</b>	<b>\$ 898,472,463</b>

The following table provides information about the credit quality of the loan portfolio using our Company's internal rating system reflecting management's risk assessment. Loans are placed on *watch* status when (1) one or more weaknesses which could jeopardize timely liquidation exists; or (2) the margin or liquidity of an asset is sufficiently tenuous that adverse trends could result in a collection problem. Loans classified as *substandard* are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified may have a well defined weakness or weaknesses that jeopardize the repayment of the debt. Such loans are characterized by the distinct possibility that our Company may sustain some loss if the deficiencies are not corrected. Loans are placed on *non-accrual* status when (1) deterioration in the financial condition of the borrower exists such that payment of full principal and interest is not expected, or (2) payment of principal or interest has been in default for a period of 90 days or more and the asset is not both well secured and in the process of collection.

## HAWTHORN BANCSHARES, INC.

## AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

	Commercial	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment and other Consumer	Total
<b>At September 30, 2011</b>							
Watch	\$ 23,346,703	\$ 8,114,728	\$ 9,374,238	\$ 13,176,253	\$ 31,455,825	\$ 519,742	\$ 85,987,489
Substandard	4,198,655	784,288	1,704,497	4,317,855	9,845,321	403,971	21,254,587
Non-accrual	1,904,977	649,985	7,231,948	3,857,488	32,849,094	167,752	46,661,244
<b>Total</b>	<b>\$ 29,450,335</b>	<b>\$ 9,549,001</b>	<b>\$ 18,310,683</b>	<b>\$ 21,351,596</b>	<b>\$ 74,150,240</b>	<b>\$ 1,091,465</b>	<b>\$ 153,903,320</b>
<b>At December 31, 2010</b>							
Watch	\$ 21,981,367	\$ 7,519,394	\$ 9,400,584	\$ 9,184,659	\$ 35,050,206	\$ 564,489	\$ 83,700,699
Substandard	2,840,703	757,637	4,242,934	4,423,219	12,635,163	441,514	25,341,170
Non-accrual	3,532,016	3,585,898	10,066,888	5,672,050	27,604,178	125,857	50,586,887
<b>Total</b>	<b>\$ 28,354,086</b>	<b>\$ 11,862,929</b>	<b>\$ 23,710,406</b>	<b>\$ 19,279,928</b>	<b>\$ 75,289,547</b>	<b>\$ 1,131,860</b>	<b>\$ 159,628,756</b>

## (3) Real Estate Acquired in Settlement of Loans

	September 30, 2011	December 31, 2010
Commercial	\$	\$ 67,421
Real estate mortgage - construction	15,010,310	13,229,199
Real estate mortgage	9,365,615	6,254,221
<b>Total</b>	<b>\$ 24,375,925</b>	<b>\$ 19,550,841</b>
Less valuation allowance for other real estate owned	(6,629,746)	(6,158,433)
<b>Total</b>	<b>\$ 17,746,179</b>	<b>\$ 13,392,408</b>
Balance at December 31, 2010		\$ 19,550,841
Additions, net of charge-offs		9,419,615
Proceeds from sales		(4,577,305)
Net loss on sales		(17,226)
<b>Total other real estate owned</b>		<b>\$ 24,375,925</b>
Less valuation allowance for other real estate owned		(6,629,746)
<b>Balance at September 30, 2011</b>		<b>\$ 17,746,179</b>

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Activity in the valuation allowance for other real estate owned in settlement of loans for the three and nine months ended September 30, 2011 and 2010, respectively, is summarized as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
<b>Balance, beginning of period</b>	\$ 6,536,607	\$	\$ 6,158,433	\$
Provision for other real estate owned	220,163		660,968	
Charge-offs	(127,024)		(189,655)	
<b>Balance, end of period</b>	\$ 6,629,746	\$	\$ 6,629,746	\$



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

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*(Unaudited)***(4) Investment Securities**

A summary of investment securities by major category, at fair value, consisted of the following at September 30, 2011 and December 31, 2010.

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
U.S. treasury	\$ 2,057,657	\$ 1,027,891
Government sponsored enterprises	56,173,402	53,341,551
Asset-backed securities	115,235,218	90,176,241
Obligations of states and political subdivisions	31,980,177	34,431,867
<b>Total available for sale securities</b>	<b>\$ 205,446,454</b>	<b>\$ 178,977,550</b>

All of our Company's investment securities are classified as available for sale, as discussed in more detail below. Asset backed securities include agency mortgage-backed securities, which are guaranteed by government sponsored entities and government agencies such as the FHLMC, FNMA and GNMA.

Investment securities which are classified as restricted equity securities primarily consist of Federal Home Loan Bank Stock and our Company's interest in statutory trusts. These securities are reported at cost in other assets in the amount of \$4,388,950 and \$6,141,950, as of September 30, 2011 and December 31, 2010, respectively.

The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2011 and December 31, 2010 are as follows:

	<b>Amortized cost</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>
<b>September 30, 2011</b>				
U.S Treasury	\$ 1,999,602	\$ 58,055	\$	\$ 2,057,657
Government sponsored enterprises	55,467,203			