

HAWTHORN BANCSHARES, INC.

Form 10-Q

May 16, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2016

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)

Missouri **43-1626350**
(State or other jurisdiction of *(I.R.S. Employer*

incorporation or organization) Identification No.)

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

(Address of principal executive offices)

(Zip Code)

(573) 761-6100

(Registrant's telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of May 12, 2016, the registrant had 5,429,485 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)

	March 31, 2016	December 31, 2015
<i>(In thousands, except per share data)</i>		
ASSETS		
Cash and due from banks	\$ 18,184	\$ 20,484
Federal funds sold and other overnight interest-bearing deposits	24,587	7,893
Cash and cash equivalents	42,771	28,377
Investment in available-for-sale securities, at fair value	245,773	235,054
Other investments and securities, at cost	8,080	8,037
Total investment securities	253,853	243,091
Loans	875,312	865,080
Allowances for loan losses	(8,631)	(8,604)
Net loans	866,681	856,476
Premises and equipment - net	36,185	36,389
Mortgage servicing rights	2,745	2,847
Other real estate and repossessed assets - net	15,471	15,992
Accrued interest receivable	4,510	4,853
Cash surrender value - life insurance	2,361	2,348
Other assets	9,579	10,548
Total assets	\$ 1,234,156	\$ 1,200,921
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits		
Non-interest bearing demand	\$ 216,886	\$ 208,035
Savings, interest checking and money market	485,759	441,080
Time deposits \$100,000 and over	126,773	132,244
Other time deposits	163,142	165,838
Total deposits	992,560	947,197
Federal funds purchased and securities sold under agreements to repurchase	41,523	56,834
Subordinated notes	49,486	49,486
Federal Home Loan Bank advances	50,000	50,000
Accrued interest payable	379	382
Other liabilities	10,355	9,736
Total liabilities	1,144,303	1,113,635
Stockholders' equity:		
Common stock, \$1 par value, authorized 15,000,000 shares; issued 5,605,202 shares, respectively	5,605	5,605
Surplus	38,554	38,549
Retained earnings	50,427	48,700

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Accumulated other comprehensive loss, net of tax	(1,054)	(2,018)
Treasury stock; 172,647 and 164,013 shares, at cost	(3,679)	(3,550)
Total stockholders' equity	89,853		87,286	
Total liabilities and stockholders' equity	\$1,234,156		\$ 1,200,921	

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

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

(In thousands, except per share amounts)	Three Months Ended March 31,	
	2016	2015
INTEREST INCOME		
Interest and fees on loans	\$ 9,987	\$ 10,074
Interest on investment securities:		
Taxable	938	902
Nontaxable	143	183
Federal funds sold and other overnight interest-bearing deposits	32	13
Dividends on other securities	76	26
Total interest income	11,176	11,198
INTEREST EXPENSE		
Interest on deposits:		
Savings, interest checking and money market	295	250
Time deposit accounts \$100,000 and over	209	209
Other time deposits	240	293
Interest on federal funds purchased and securities sold under agreements to repurchase	23	8
Interest on subordinated notes	354	313
Interest on Federal Home Loan Bank advances	207	147
Total interest expense	1,328	1,220
Net interest income	9,848	9,978
Provision for loan losses	250	0
Net interest income after provision for loan losses	9,598	9,978
NON-INTEREST INCOME		
Service charges and other fees	834	831
Bank card income and fees	634	587
Trust department income	218	204
Real estate servicing fees, net	54	(5)
Gain on sale of mortgage loans, net	165	346
Gain on sale of investment securities	472	0
Other	71	24
Total non-interest income	2,448	1,987
NON-INTEREST EXPENSE		
Salaries and employee benefits	5,350	5,304
Occupancy expense, net	634	663
Furniture and equipment expense	411	431
Processing, network, and ban card expense	772	789
Legal, examination, and professional fees	333	272
FDIC insurance assessment	176	240

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Advertising and promotion	209	237
Postage, printing, and supplies	237	271
Real estate foreclosure expense (gains), net	141	(181)
Other	820	682
Total non-interest expense	9,083	8,708
Income before income taxes	2,963	3,257
Income tax expense	965	1,119
Net income	1,998	2,138
Basic earnings per share	\$ 0.37	\$ 0.39
Diluted earnings per share	\$ 0.37	\$ 0.39

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

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

(In thousands)	Three Months Ended	
	March 31, 2016	2015
Net income	\$ 1,998	\$ 2,138
Other comprehensive income, net of tax		
Investment securities available-for-sale:		
Unrealized gain on investment securities available-for-sale, net of tax	1,245	484
Adjustment for gain on sale of investment securities, net of tax	(293)	0
Defined benefit pension plans:		
Amortization of prior service cost included in net periodic pension cost, net of tax	12	23
Total other comprehensive income	964	507
Total comprehensive income	\$ 2,962	\$ 2,645

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

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

(In thousands)	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stock - holders' Equity
Balance, December 31, 2014	\$ 5,396	\$35,901	\$44,016	\$ (1,228) \$ (3,517)	\$80,568
Net income	0	0	2,138	0	0	2,138
Other comprehensive income	0	0	0	507	0	507
Stock based compensation expense	0	4	0	0	0	4
Cash dividends declared, common stock	0	0	(261)	0	0	(261)
Balance, March 31, 2015	\$ 5,396	\$35,905	\$45,893	\$ (721) \$ (3,517)	\$82,956
Balance, December 31, 2015	\$ 5,605	\$38,549	\$48,700	\$ (2,018) \$ (3,550)	\$87,286
Net income	0	0	1,998	0	0	1,998
Other comprehensive income	0	0	0	964	0	964
Stock based compensation expense	0	5	0	0	0	5
Purchase of treasury stock	0	0	0	0	(129)	(129)
Cash dividends declared, common stock	0	0	(271)	0	0	(271)
Balance, March 31, 2016	\$ 5,605	\$38,554	\$50,427	\$ (1,054) \$ (3,679)	\$89,853

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

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

(In thousands)	Three Months Ended March	
	31, 2016	2015
Cash flows from operating activities:		
Net income	\$ 1,998	\$ 2,138
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	250	0
Depreciation expense	485	452
Net amortization of investment securities, premiums, and discounts	365	291
Stock based compensation expense	5	4
Change in fair value of mortgage servicing rights	155	219
Gain on sale of investment securities	(472)	0
Gain on sales and dispositions of premises and equipment	(6)	(10)
Gain on sales and dispositions of other real estate and repossessed assets	(49)	(140)
Provision for other real estate owned	38	6
Decrease in accrued interest receivable	343	521
Increase in cash surrender value -life insurance	(13)	(18)
Decrease in other assets	364	1,078
(Decrease) increase in accrued interest payable	(3)	3
Increase in other liabilities	619	400
Origination of mortgage loans for sale	(7,707)	(14,876)
Proceeds from the sale of mortgage loans	7,435	11,947
Gain on sale of mortgage loans, net	(165)	(346)
Other, net	(52)	(44)
Net cash provided by operating activities	3,590	1,625
Cash flows from investing activities:		
Net (increase) decrease in loans	(10,760)	1,340
Purchase of available-for-sale debt securities	(66,459)	(52,626)
Proceeds from maturities of available-for-sale debt securities	9,120	7,282
Proceeds from calls of available-for-sale debt securities	4,175	9,875
Proceeds from sales of available-for-sale debt securities	44,087	0
Proceeds from sales of FHLB stock	0	120
Purchases of FHLB stock	(43)	(35)
Purchases of premises and equipment	(248)	(253)
Proceeds from sales of premises and equipment	6	10
Proceeds from sales of other real estate and foreclosed assets	1,274	883
Net cash used in investing activities	(18,848)	(33,404)
Cash flows from financing activities:		
Net increase (decrease) in demand deposits	8,851	(8,045)
Net increase in interest-bearing transaction accounts	44,679	32,348
Net decrease in time deposits	(8,167)	(706)

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Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase	(15,311)	4,393
Repayment of FHLB advances	0	(8,000)
FHLB advances	0	5,000
Purchase of treasury stock	(129)	0
Cash dividends paid - common stock	(271)	(262)
Net cash provided by financing activities	29,652	24,728
Net increase (decrease) in cash and cash equivalents	14,394	(7,051)
Cash and cash equivalents, beginning of period	28,377	42,809
Cash and cash equivalents, end of period	\$ 42,771	\$ 35,758

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

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

(In thousands)	Three Months Ended March 31,	
	2016	2015
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	\$ 1,332	\$ 1,219
Income taxes	\$ 430	\$ 14
Noncash investing activities:		
Other real estate and repossessed assets acquired in settlement of loans	\$ 742	\$ 605

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

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(1) Summary of Significant Accounting Policies

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

The accompanying unaudited consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q, and Rule 10-01 of Regulation S-X. Accordingly, the unaudited consolidated financial statements do not include all of the information and disclosures required by U.S. GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. Certain amounts in the 2015 condensed consolidated financial statements have been reclassified to conform to the 2016 condensed consolidated presentation. Such reclassifications have no effect on previously reported net income or stockholders' equity.

The preparation of the consolidated financial statements includes 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. The Company's management has evaluated and did not identify any subsequent events or transactions requiring recognition or disclosure in the consolidated financial statements.

Stock Dividend On July 1, 2015, the Company paid a special stock dividend of four percent to shareholders of record at the close of business on June 15, 2015. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

The following represents significant new accounting principles adopted in 2016:

Consolidation The FASB issued ASU No. 2015-02, *Amendments to the Consolidation Analysis*, in February 2015. The amendment substantially changes the way reporting entities are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the new amendment. Specifically, the amendments modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (VIEs) or voting interest entities, eliminate the presumption that a general partner should consolidate a limited partnership, and affect the consolidation analysis of reporting entities that are involved with VIEs. The amendments were effective for interim and annual periods beginning January 1, 2016. The adoption did not have a significant effect on the Company's consolidated financial statements.

Intangible Assets The FASB issued ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*, in April 2015. The amendments provide guidance to customers about whether a cloud computing arrangement includes a software license. Arrangements containing a license should be recorded as consistent with the acquisition of software licenses, whereas arrangements that do not include a software license should be recorded as consistent with the accounting for service contracts. These amendments were effective for interim and annual periods beginning January 1, 2016. The adoption did not have a significant effect on the Company's consolidated financial statements.

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(2) Loans and Allowance for Loan Losses

Loans

A summary of loans, by major class within the Company's loan portfolio, at March 31, 2016 and December 31, 2015 is as follows:

(in thousands)	March 31, 2016	December 31, 2015
Commercial, financial, and agricultural	\$ 148,040	\$ 149,091
Real estate construction - residential	18,017	16,895
Real estate construction - commercial	36,322	33,943
Real estate mortgage - residential	254,933	256,086
Real estate mortgage - commercial	392,991	385,869
Installment and other consumer	25,009	23,196
Total loans	\$ 875,312	\$ 865,080

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the communities surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, Branson and the greater Kansas City metropolitan area. 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 automotive vehicles. At March 31, 2016, loans with a carrying value of \$435.7 million, or \$362.4 million fair value, were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit.

Allowance for Loan Losses

The following is a summary of the allowance for loan losses during the periods indicated.

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Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(in thousands)	Three Months Ended March 31, 2016							
	Commercial	Real Estate	Real Estate	Real Estate	Real Estate	Installment		
	Financial & Agricultural	Construction Residential	Construction Commercial	Mortgage Residential	Mortgage Commercial	Loans to Individuals	Un-allocated	Total
Balance at beginning of period	\$2,153	\$ 59	\$ 644	\$ 2,439	\$ 2,935	\$ 273	\$ 101	\$8,604
Additions:								
Provision for loan losses	(12)	(15)	33	32	276	(6)	(58)	250
Deductions:								
Loans charged off	103	0	1	206	82	56	0	448
Less recoveries on loans	(97)	0	(11)	(8)	(61)	(48)	0	(225)
Net loans charged off	6	0	(10)	198	21	8	0	223
Balance at end of period	\$2,135	\$ 44	\$ 687	\$ 2,273	\$ 3,190	\$ 259	\$ 43	\$8,631

(in thousands)	Three Months Ended March 31, 2015							
	Commercial	Real Estate	Real Estate	Real Estate	Real Estate	Installment		
	Financial & Agricultural	Construction Residential	Construction Commercial	Mortgage Residential	Mortgage Commercial	Loans to Individuals	Un-allocated	Total
Balance at beginning of period	\$1,779	\$ 171	\$ 466	\$ 2,527	\$ 3,846	\$ 270	\$ 40	\$9,099
Additions:								
Provision for loan losses	(185)	(300)	(92)	241	259	(67)	144	0
Deductions:								
Loans charged off	28	0	0	71	24	48	0	171
Less recoveries on loans	(575)	(177)	0	(12)	(34)	(35)	0	(833)
Net loans charged off	(547)	(177)	0	59	(10)	13	0	(662)
Balance at end of period	\$2,141	\$ 48	\$ 374	\$ 2,709	\$ 4,115	\$ 190	\$ 184	\$9,761

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

Beginning in the first quarter of 2016, the Company began to lengthen its look-back period with the intent to increase such period from three to five years over the next two years. The Company believes that the five-year look-back period, which is consistent with the Company's practices prior to the start of the economic recession in 2008, provides a representative historical loss period in the current economic environment.

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

The following table provides the balance in the allowance for loan losses at March 31, 2016 and December 31, 2015, and the related loan balance by impairment methodology.

	Commercial, Financial, and Agricultural	Real Estate Construction Residential	Real Estate Construction Commercial	Real Estate Mortgage Residential	Real Estate Mortgage Commercial	Installment Loans to Individuals	Un- allocated	Total
(in thousands)								
March 31, 2016								
Allowance for loan losses:								
Individually evaluated for impairment	\$ 260	\$ 0	\$ 8	\$ 980	\$ 69	\$ 31	\$ 0	\$ 1,348
Collectively evaluated for impairment	1,875	44	679	1,293	3,121	228	43	7,283
Total	\$ 2,135	\$ 44	\$ 687	\$ 2,273	\$ 3,190	\$ 259	\$ 43	\$ 8,631
Loans outstanding:								
Individually evaluated for impairment	\$ 941	\$ 0	\$ 52	\$ 5,365	\$ 2,435	\$ 131	\$ 0	\$ 8,924
Collectively evaluated for impairment	147,099	18,017	36,270	249,568	390,556	24,878	0	866,388
Total	\$ 148,040	\$ 18,017	\$ 36,322	\$ 254,933	\$ 392,991	\$ 25,009	\$ 0	\$ 875,312
December 31, 2015								
Allowance for loan losses:								
Individually evaluated for impairment	\$ 285	\$ 0	\$ 15	\$ 955	\$ 266	\$ 19	\$ 0	\$ 1,540
Collectively evaluated for impairment	1,868	59	629	1,484	2,669	254	101	7,064
Total	\$ 2,153	\$ 59	\$ 644	\$ 2,439	\$ 2,935	\$ 273	\$ 101	\$ 8,604
Loans outstanding:								

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Individually evaluated for impairment	\$ 1,005	\$ 0	\$ 102	\$ 5,936	\$ 3,081	\$ 144	\$ 0	\$ 10,268
Collectively evaluated for impairment	148,086	16,895	33,841	250,150	382,788	23,052	0	854,812
Total	\$ 149,091	\$ 16,895	\$ 33,943	\$ 256,086	\$ 385,869	\$ 23,196	\$ 0	\$ 865,080

Impaired Loans

Loans evaluated under ASC 310-10-35 include loans which are individually evaluated for impairment. All other loans are collectively evaluated for impairment under ASC 450-20. Impaired loans individually evaluated for impairment totaled \$8.9 million and \$10.3 million at March 31, 2016 and December 31, 2015, respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings (TDRs).

The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At March 31, 2016 and December 31, 2015, \$5.5 million and \$6.4 million, respectively, of impaired loans were evaluated based on the fair value less estimated selling costs of the loan's collateral. Once the impairment amount is calculated a specific reserve allocation is recorded. At March 31, 2016, \$1.3 million of the Company's allowance for loan losses was allocated to impaired loans totaling \$8.9 million compared to \$1.5 million of the Company's allowance for loan losses allocated to impaired loans totaling approximately \$10.3 million at December 31, 2015. Management determined that \$3.8 million, or 42%, of total impaired loans required no reserve allocation at March 31, 2016 compared to \$4.5 million, or 44%, at December 31, 2015 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

Hawthorn Bancshares, Inc.
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Notes to the Consolidated Financial Statements

(Unaudited)

The categories of impaired loans at March 31, 2016 and December 31, 2015 are as follows:

	March 31,	December 31,
(in thousands)	2016	2015
Non-accrual loans	\$ 3,072	\$ 4,418
Performing TDRs	5,852	5,850
Total impaired loans	\$ 8,924	\$ 10,268

The following tables provide additional information about impaired loans at March 31, 2016 and December 31, 2015, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided.

(in thousands)	Recorded Investment	Unpaid Principal Balance	Specific Reserves
March 31, 2016			
With no related allowance recorded:			
Commercial, financial and agricultural	\$ 433	\$ 433	\$ 0
Real estate - residential	1,215	1,219	0
Real estate - commercial	2,123	2,523	0
Total	\$ 3,771	\$ 4,175	\$ 0
With an allowance recorded:			
Commercial, financial and agricultural	\$ 508	\$ 526	\$ 260
Real estate - construction commercial	52	56	8
Real estate - residential	4,150	4,178	980
Real estate - commercial	312	371	69
Consumer	131	171	31
Total	\$ 5,153	\$ 5,302	\$ 1,348
Total impaired loans	\$ 8,924	\$ 9,477	\$ 1,348

(in thousands)	Recorded	Unpaid	Specific
	Investment	Principal	Reserves
December 31, 2015			
With no related allowance recorded:			
Commercial, financial and agricultural	\$ 448	\$ 450	\$ 0
Real estate - residential	1,645	1,712	0
Real estate - commercial	2,446	2,572	0
Total	\$ 4,539	\$ 4,734	\$ 0
With an allowance recorded:			
Commercial, financial and agricultural	\$ 557	\$ 572	\$ 285
Real estate - construction commercial	102	115	15
Real estate - residential	4,291	4,320	955
Real estate - commercial	635	884	266
Consumer	144	182	19
Total	\$ 5,729	\$ 6,073	\$ 1,540
Total impaired loans	\$ 10,268	\$ 10,807	\$ 1,540

Hawthorn Bancshares, Inc.
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Notes to the Consolidated Financial Statements

(Unaudited)

The following table presents by class, information related to the average recorded investment and interest income recognized on impaired loans during the periods indicated.

	Three Months Ended March 31,			
	2016		2015	
	Average Recorded For the Investment Period Ended	Interest Recognized	Average Recorded For the Investment Period Ended	Interest Recognized
(in thousands)				
With no related allowance recorded:				
Commercial, financial and agricultural	\$ 1,520	\$ 15	\$ 5,525	\$ 20
Real estate - construction residential	0	0	2,143	0
Real estate - construction commercial	118	0	2,319	0
Real estate - residential	1,513	39	3,180	12
Real estate - commercial	2,622	42	10,899	65
Consumer	0	0	28	0
Total	\$ 5,773	\$ 96	\$ 24,094	\$ 97
With an allowance recorded:				
Commercial, financial and agricultural	\$ 984	\$ 12	\$ 1,798	\$ 6
Real estate - construction commercial	65	0	0	0
Real estate - residential	4,553	120	4,457	26
Real estate - commercial	764	0	1,286	0
Consumer	135	0	237	0
Total	\$ 6,501	\$ 132	\$ 7,778	\$ 32
Total impaired loans	\$ 12,274	\$ 228	\$ 31,872	\$ 129

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 \$228,000 and \$129,000, for the three months ended March 31, 2016 and 2015, respectively. The average recorded investment in impaired loans is calculated on a monthly basis during the periods reported.

Delinquent and Non-Accrual Loans

The delinquency status of loans is determined based on the contractual terms of the notes. Borrowers are generally classified as delinquent once payments become 30 days or more past due. The Company's policy is to discontinue the accrual of interest income on any loan when, in the opinion of management, the ultimate collectibility of interest or principal is no longer probable. In general, loans are placed on non-accrual when they become 90 days or more past due. However, management considers many factors before placing a loan on non-accrual, including the delinquency status of the loan, the overall financial condition of the borrower, the progress of management's collection efforts and the value of the underlying collateral. Non-accrual loans are returned to accrual status when, in the opinion of management, the financial condition of the borrower indicates that the timely collectibility of interest and principal is probable and the borrower demonstrates the ability to pay under the terms of the note through a sustained period of repayment performance, which is generally six months.

The following table provides aging information for the Company's past due and non-accrual loans at March 31, 2016 and December 31, 2015.

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(in thousands)	Current or Less Than 30 Days Past Due	30 - 89 Days Past Due	90 Days Past Due And Still Accruing	Non-Accrual	Total
March 31, 2016					
Commercial, Financial, and Agricultural	\$ 147,386	\$ 395	\$ 0	\$ 259	\$ 148,040
Real Estate Construction - Residential	18,017	0	0	0	18,017
Real Estate Construction - Commercial	36,270	0	0	52	36,322
Real Estate Mortgage - Residential	251,366	1,783	58	1,726	254,933
Real Estate Mortgage - Commercial	391,798	289	0	904	392,991
Installment and Other Consumer	24,766	104	8	131	25,009
Total	\$ 869,603	\$ 2,571	\$ 66	\$ 3,072	\$ 875,312
December 31, 2015					
Commercial, Financial, and Agricultural	\$ 148,597	\$ 185	\$ 1	\$ 308	\$ 149,091
Real Estate Construction - Residential	16,830	0	0	0	16,830
Real Estate Construction - Commercial	33,472	65	0	102	33,639
Real Estate Mortgage - Residential	251,253	2,511	0	2,322	256,086
Real Estate Mortgage - Commercial	384,053	643	0	1,542	386,238
Installment and Other Consumer	22,840	207	5	144	23,196
Total	\$ 857,045	\$ 3,611	\$ 6	\$ 4,418	\$ 865,080

Credit Quality

The Company categorizes loans into risk categories based upon an internal rating system reflecting management's risk assessment. Loans are placed on *watch* status when one or more weaknesses that may result in the deterioration of the repayment exits or the Company's credit position at some future date. Loans classified as *substandard* are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Loans so classified may have a well defined weakness or weaknesses that jeopardize the repayment of the debt. Such loans are characterized by the distinct possibility that the Company may sustain some loss if the deficiencies are not corrected. A loan is classified as a *troubled debt restructuring (TDR)* when a borrower is experiencing financial difficulties that lead to the restructuring of a loan, and the Company grants concessions to the borrower in the restructuring that it

would not otherwise consider. Loans classified as TDRs which are accruing interest are classified as performing TDRs. Loans classified as TDRs which are not accruing interest are classified as nonperforming TDRs and are included with all other nonaccrual loans for presentation purposes. It is the Company's policy to discontinue the accrual of interest income on loans when management believes that the collection of interest or principal is doubtful. Loans are placed on *non-accrual* status when (1) deterioration in the financial condition of the borrower exists for which payment of full principal and interest is not expected, or (2) payment of principal or interest has been in default for a period of 90 days or more and the asset is not both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectability of such principal; otherwise, such receipts are recorded as interest income on a cash basis.

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The following table presents the risk categories by class at March 31, 2016 and December 31, 2015.

<i>(in thousands)</i>	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment and other Consumer	Total
At March 31, 2016							
Watch	\$ 7,152	\$ 1,064	\$ 1,162	\$ 23,291	\$ 22,909	\$ 0	\$55,578
Substandard	230	0	37	1,929	1,613	0	3,809
Performing TDRs	683	0	0	3,639	1,530	0	5,852
Non-accrual	259	0	52	1,726	904	131	3,072
Total	\$ 8,324	\$ 1,064	\$ 1,251	\$ 30,585	\$ 26,956	\$ 131	\$68,311
At December 31, 2015							
Watch	\$ 8,663	\$ 1,267	\$ 1,296	\$ 22,191	\$ 24,303	\$ 186	\$57,906
Substandard	421	0	37	3,737	1,485	36	5,716
Performing TDRs	697	0	0	3,615	1,538	0	5,850
Non-accrual	308	0	102	2,322	1,542	144	4,418
Total	\$ 10,089	\$ 1,267	\$ 1,435	\$ 31,865	\$ 28,868	\$ 366	\$73,890

Troubled Debt Restructurings

At March 31, 2016, loans classified as TDRs totaled \$6.0 million, of which \$194,000 were classified as nonperforming TDRs and included in non-accrual loans and \$5.9 million were classified as performing TDRs. At December 31, 2015, loans classified as TDRs totaled \$6.4 million, of which \$527,000 were classified as nonperforming TDRs and included in non-accrual loans and \$5.9 million were classified as performing TDRs. Both performing and nonperforming TDRs are considered impaired loans. When an individual loan is determined to be a

TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the underlying collateral less applicable selling costs. Accordingly, specific reserves of \$764,000 and \$910,000 related to TDRs were allocated to the allowance for loan losses at March 31, 2016 and December 31, 2015, respectively.

The following table summarizes loans that were modified as TDRs during the periods indicated.

(in thousands)	Three Months Ended March 31, 2016			2015		
	Recorded Investment (1)			Recorded Investment (1)		
	Number of Pre- Modification Contracts		Post- Modification	Number of Pre- Modification Contracts		Post- Modification
Troubled Debt Restructurings						
Commercial, financial and agricultural	0	\$ 0	\$ 0	3	\$ 250	\$ 250
Real estate mortgage - residential	1	78,148	78,148	2	144	144
Real estate mortgage - commercial	0	0	0	3	473	473
Total	1	\$ 78,148	\$ 78,148	8	\$ 867	\$ 867

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

The Company's portfolio of loans classified as TDRs include concessions for the borrower given financial condition such as interest rates below the current market rate, deferring principal payments, and extending maturity dates. During the three months ended March 31, 2016, one loan meeting the TDR criteria was modified compared to eight loans during the three months ended March 31, 2015. There were no loans modified as a TDR that defaulted during the three months ended March 31, 2016 and 2015, respectively, and within twelve months of their modification date. See *Lending and Credit Management* section for further information.

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(3) Other Real Estate and Repossessed Assets

(in thousands)	March 31, 2016	December 31, 2015
Commercial	\$ 1,444	\$ 1,445
Real estate construction - commercial	12,380	12,380
Real estate mortgage - residential	835	477
Real estate mortgage - commercial	4,037	4,923
Total	\$ 18,696	\$ 19,225
Less valuation allowance for other real estate owned	(3,225)	(3,233)
Total other real estate and repossessed assets	\$ 15,471	\$ 15,992

Changes in the net carrying amount of other real estate and repossessed assets were as follows for the periods indicated:

	Three Months Ended March 31,	
	2016	2015
Balance at beginning of period	\$ 19,225	\$ 15,140
Additions	742	603
Proceeds from sales	(1,274)	(883)
Charge-offs against the valuation allowance for other real estate owned, net	(46)	(16)
Net gain on sales	49	140
Total other real estate and repossessed assets	\$ 18,696	\$ 14,984
Less valuation allowance for other real estate owned	(3,225)	(3,233)
Balance at end of period	\$ 15,471	\$ 11,751

During the three months ended March 31, 2016 and 2015, net charge-offs against the allowance for loan losses at the time of foreclosure were approximately \$381,000 and \$41,000, respectively. At March 31, 2016 \$565,000 of consumer mortgage loans secured by residential real estate properties were in the process of foreclosure compared to

\$390,000 at December 31, 2015.

Activity in the valuation allowance for other real estate owned was as follows for the periods indicated:

(in thousands)	Three Months Ended March 31,	
	2016	2015
Balance, beginning of period	\$ 3,233	\$ 3,255
Provision for other real estate owned	38	(6)
Charge-offs	(46)	(16)
Balance, end of period	\$ 3,225	\$ 3,233

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(4) Investment Securities

The amortized cost and fair value of debt securities classified as available-for-sale at March 31, 2016 and December 31, 2015 were as follows:

<i>(in thousands)</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair value
March 31, 2016				
Government sponsored enterprises	\$42,111	\$ 110	\$ 9	42,212
Asset-backed securities	175,869	866	892	175,843
Obligations of states and political subdivisions	27,212	523	17	27,718
Total available-for-sale securities	\$245,192	\$ 1,499	\$ 918	\$245,773
December 31, 2015				
Government sponsored enterprises	\$73,605	\$ 127	\$ 235	\$73,497
Asset-backed securities	130,179	440	1,768	128,851
Obligations of states and political subdivisions	32,224	493	11	32,706
Total available-for-sale securities	\$236,008	\$ 1,060	\$ 2,014	\$235,054

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

Other investments and securities primarily consist of Federal Home Loan Bank stock and the Company's interest in statutory trusts. These securities are reported at cost in the amount of \$8.1 and \$8.0 million as of March 31, 2016 and

December 31, 2015, respectively.

Debt securities with carrying values aggregating approximately \$202.3 million and \$182.7 million at March 31, 2016 and December 31, 2015, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

The amortized cost and fair value of debt securities classified as available-for-sale at March 31, 2016, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without prepayment penalties.

<i>(in thousands)</i>	Amortized Cost	Fair Value
Due in one year or less	\$ 18,149	\$ 18,155
Due after one year through five years	40,630	40,934
Due after five years through ten years	10,013	10,312
Due after ten years	531	529
Total	69,323	69,930
Asset-backed securities	175,869	175,843
Total available-for-sale securities	\$ 245,192	\$ 245,773

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Gross unrealized losses on debt securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2016 and December 31, 2015 were as follows:

(in thousands)	Less than 12 months		12 months or more		Total	Total
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
At March 31, 2016						
Government sponsored enterprises	\$ 17,997	\$ (9)	\$ 0	\$ 0	\$ 17,997	\$ (9)
Asset-backed securities	57,446	(523)	40,267	(369)	97,713	(892)
political subdivisions	3,039	(16)	251	(1)	3,290	(17)
Total	\$ 78,482	\$ (548)	\$ 40,518	\$ (370)	\$ 119,000	\$ (918)

(in thousands)

At December 31, 2015

Government sponsored enterprises	\$ 43,539	\$ (222)	\$ 1,002	\$ (13)	\$ 44,541	\$ (235)
Asset-backed securities	56,095	(620)	43,576	(1,148)	99,671	(1,768)
Obligations of states and political subdivisions	2,571	(6)	718	(5)	3,289	(11)
Total	\$ 102,205	\$ (848)	\$ 45,296	\$ (1,166)	\$ 147,501	\$ (2,014)

The total available for sale portfolio consisted of approximately 268 securities at March 31, 2016. The portfolio included 67 securities having an aggregate fair value of \$119.0 million that were in a loss position at March 31, 2016. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled \$40.5 million at fair value. The \$918,000 aggregate unrealized loss included in accumulated other comprehensive income at March 31, 2016 was caused by interest rate fluctuations.

The total available for sale portfolio consisted of approximately 316 securities at December 31, 2015. The portfolio included 111 securities having an aggregate fair value of \$147.5 million that were in a loss position at December 31,

2015. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled \$45.3 million at fair value. The \$2.0 million aggregate unrealized loss included in accumulated other comprehensive income at December 31, 2015 was caused by interest rate fluctuations.

Because the decline in fair value is attributable to changes in interest rates and not credit quality, these investments were not considered other-than-temporarily impaired at March 31, 2016 and December 31, 2015, respectively. In addition, the Company does not have the intent to sell these investments over the period of recovery, and it is not more likely than not that it will be required to sell such investment securities.

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

(in thousands)	Three Months Ended March 31,	
	2016	2015
Gains realized on sales	\$ 472	\$ 0
Losses realized on sales	0	0
Other-than-temporary impairment recognized	0	0
Investment securities gains	\$ 472	\$ 0

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(5) Intangible Assets

Mortgage Servicing Rights

At March 31, 2016, the Company was servicing approximately \$308.1 million of loans sold to the secondary market compared to \$312.1 million at December 31, 2015, and \$312.3 million at March 31, 2015. Mortgage loan servicing fees, reported as non-interest income, earned on loans sold were \$210,000 for the three ended March 31, 2016 compared to \$214,000 for the three months ended March 31, 2015, respectively.

The table below presents changes in mortgage servicing rights (MSRs) for the periods indicated.

(in thousands)	Three Months Ended March 31,	
	2016	2015
Balance at beginning of period	\$ 2,847	\$ 2,762
Originated mortgage servicing rights	53	119
Changes in fair value:		
Due to change in model inputs and assumptions (1)	(3)	(41)
Other changes in fair value (2)	(152)	(178)
Balance at end of period	\$ 2,745	\$ 2,662

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

(2) Other changes in fair value reflect changes due to customer payments and passage of time.

The following key data and assumptions were used in estimating the fair value of the Company's MSR's as of the three months ended March 31, 2016 and 2015:

	Three Months Ended March 31,			
	2016		2015	
Weighted average constant prepayment rate	10.30	%	11.19	%
Weighted average note rate	3.91	%	3.94	%
Weighted average discount rate	9.19	%	9.26	%
Weighted average expected life (in years)	5.70		5.40	

(6) Federal funds purchased and securities sold under agreements to repurchase

	March 31,	December 31,
	2016	2015
Federal funds purchased	\$ 0	\$ 0
Repurchase agreements	41,523	56,834
Total	\$ 41,523	\$ 56,834

The Company offers a sweep account program whereby amounts in excess of an established limit are "swept" from the customer's demand deposit account on a daily basis into retail repurchase agreements pursuant to individual repurchase agreements between the Company and its customers. Repurchase agreements are agreements to sell securities subject to an obligation to repurchase the same or similar securities. They are accounted for as collateralized financing transactions, not as sales and purchases of the securities portfolio. The securities collateral pledged for the repurchase agreements with customers is maintained by a designated third party custodian. The collateral amounts pledged to repurchase agreements by remaining maturity in the table below are limited to the outstanding balances of the related asset or liability; thus amounts of excess collateral are not shown.

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Repurchase Agreements	Remaining Contractual Maturity of the Agreements			
	Overnight and continuous	Less than 90 days	Greater than 90 days	Total
(in thousands)				
At March 31, 2016				
Government sponsored enterprises	\$ 23,854	\$ 0	\$ 0	\$ 23,854
Asset-backed securities	17,669	0	0	17,669
Total	\$ 41,523	\$ 0	\$ 0	\$ 41,523

Repurchase Agreements	Remaining Contractual Maturity of the Agreements			
	Overnight and continuous	Less than 90 days	Greater than 90 days	Total
(in thousands)				
At December 31, 2015				
Government sponsored enterprises	\$ 46,819	\$ 0	\$ 0	\$ 46,819
Asset-backed securities	10,015	0	0	10,015
Total	\$ 56,834	\$ 0	\$ 0	\$ 56,834

(7) Income Taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 32.6% for the three months ended March 31, 2016 compared to 34.4% for the three months ended March 31, 2015. The decrease in tax rates quarter over quarter is primarily due to an immaterial return to provision adjustment.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, taxable income available in carryback years, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely

than not the Company will realize the benefits of these temporary differences at March 31, 2016 and, therefore, did not establish a valuation reserve.

(8) Stockholders' Equity

Accumulated Other Comprehensive (Loss) Income

The following details the change in the components of the Company's accumulated other comprehensive (loss) income for the three months ended March 31, 2016 and 2015:

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	Three months ended March 31, 2016		
	Unrealized Gain (Loss) on Securities (1)	Unrecognized Net Pension and Postretirement Costs (2)	Accumulated Other Comprehensive (Loss) Income
(in thousands)			
Balance at beginning of period	\$ (591)	\$ (1,427)	\$ (2,018)
Other comprehensive income, before reclassifications	2,006	21	2,027
Amounts reclassified from accumulated other comprehensive income	(472)	0	(472)
Current period other comprehensive income, before tax	1,534	21	1,555
Income tax expense	(583)	(8)	(591)
Current period other comprehensive income, net of tax	951	13	964
Balance at end of period	\$ 360	\$ (1,414)	\$ (1,054)

	Three months ended March 31, 2015		
	Unrealized Gain (Loss) on Securities (1)	Unrecognized Net Pension and Postretirement Costs (2)	Accumulated Other Comprehensive (Loss) Income
(in thousands)			
Balance at beginning of period	\$ 214	\$ (1,442)	\$ (1,228)
Other comprehensive income, before reclassifications	781	0	781
Amounts reclassified from accumulated other comprehensive income	0	36	36
Current period other comprehensive income, before tax	781	36	817

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Income tax expense	(297)	(13)	(310)
Current period other comprehensive income, net of tax	484	23	507
Balance at end of period	\$ 698	\$ (1,419)	\$ (721)

(1) The pre-tax amounts reclassified from accumulated other comprehensive income (loss) are included in *gain on sale of investment securities* in the consolidated statements of income.

(2) The pre-tax amounts reclassified from accumulated other comprehensive income (loss) are included in the computation of net periodic pension cost.

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(9)

Employee Benefit Plans

Employee Benefits

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

(in thousands)	Three Months Ended March 31,	
	2016	2015
Payroll taxes	\$ 296	\$ 329
Medical plans	512	508
401k match and profit sharing	181	272
Pension plan	307	348
Other	16	19
Total employee benefits	\$ 1,312	\$ 1,476

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

Pension

The Company provides a noncontributory defined benefit pension plan for all full-time employees. An employer is required to recognize the funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. Under the Company's funding policy for the defined benefit pension plan, contributions are made to a trust as necessary to provide for current service and for any unfunded accrued actuarial liabilities over a reasonable period. To the extent that these requirements are fully covered by assets in the trust, a contribution might not be made in a particular year. A pension contribution in the amount of \$772,000 was made on April 15, 2016.

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

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

(in thousands)	Estimated 2016	Actual 2015
Service cost - benefits earned during the year	\$ 1,179	\$ 1,325
Interest costs on projected benefit obligations	956	838
Expected return on plan assets	(1,057)	(957)
Expected administrative expenses	70	40
Amortization of prior service cost	79	79
Amortization of unrecognized net loss	0	66
Net periodic pension expense	\$ 1,227	\$ 1,391
Pension expense - three months ended March 31, (actual)	\$ 307	\$ 348

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(10)

Stock Compensation

The Company's stock option plan provides for the grant of options to purchase up to 592,168 shares of the Company's common stock to officers and other key employees of the Company and its subsidiaries. All options have been granted at exercise prices equal to fair value and vest over periods ranging from four to five years.

The following table summarizes the Company's stock option activity:

	Number of Shares	Weighted average Exercise Price	Weighted Average Contractual Term (in years)	Aggregate Intrinsic Value (\$000)
Outstanding, beginning of period	62,745	\$ 21.50		
Granted	0	0.00		
Exercised	0	0.00		
Forfeited or expired	(20,007)	22.77		
Outstanding, March 31, 2016	42,738	\$ 20.91	1.75	\$ 0.00
Exercisable, March 31, 2016	35,255	\$ 21.96	1.59	\$ 0.00

Options have been adjusted to reflect a 4% stock dividend paid on July 1, 2015.

Total stock-based compensation expense was \$5,000 and \$4,000 for the three months ended March 31, 2016 and 2015, respectively. As of March 31, 2016, the total unrecognized compensation expense related to non-vested stock awards was \$15,000 and the related weighted average period over which it is expected to be recognized is approximately 0.47 years.

(11)

Earnings per Share

Stock Dividend On July 1, 2015, the Company paid a special stock dividend of 4% to common shareholders of record at the close of business on June 15, 2015. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

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

(dollars in thousands, except per share data)	Three Months Ended March 31,	
	2016	2015
Basic earnings per share:		
Net income available to shareholders	\$ 1,998	\$ 2,138
Basic earnings per share	\$ 0.37	\$ 0.39
Diluted earnings per share:		
Net income available to shareholders	\$ 1,998	\$ 2,138
Average shares outstanding	5,436,604	5,443,344
Effect of dilutive stock options	0	0
Average shares outstanding including dilutive stock options	5,436,604	5,443,344
Diluted earnings per share	\$ 0.37	0.39

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

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period, except when the Company has a loss from continuing operations available to 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.

Options to purchase 42,738 and 84,830 shares during the three months ended March 31, 2016 and 2015, respectively, were not included in the respective computations of diluted earnings per share because the exercise price of the option, when combined with the effect of the unamortized compensation expense, was greater than the average market price of the common shares and were considered anti-dilutive.

Repurchase Program On August 6, 2015, the Board of Directors authorized a share repurchase plan to purchase through open market transactions \$2.0 million market value of the Company's common stock. During 2016, the Company repurchased 8,635 shares of common stock pursuant to the plan at an average price of \$14.94 per share.

The table below shows activity in the outstanding shares of the Company's common stock during the past three years. Shares in the table below are presented on a historical basis and have not been restated for the annual 4% stock dividends.

	Number of shares		
	March 31, 2016	December 31, 2015	March 31, 2015
Outstanding, beginning of year	5,441,190	5,233,986	5,233,986
Issuance of stock:			
4% stock dividend	0	209,359	209,359
Purchase of treasury stock	(8,635)	(2,155)	0
Outstanding, end of year	5,432,555	5,441,190	5,443,344

Except as noted in the above table, all share and per share amounts in this note have been restated for the 4% common stock dividend distributed July 1, 2015.

(12)

Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain financial and nonfinancial assets and liabilities. The FASB ASC Topic 820, *Fair Value Measurements 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 March 31, 2016 and December 31, 2015, respectively, there were no transfers into or out of Levels 1-3.

The fair value hierarchy is as follows:

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

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

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

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

The Company is required to disclose assets and liabilities measured at fair value on a recurring basis separate from those measured at fair value on a nonrecurring basis. Nonfinancial assets measured at fair value on a nonrecurring basis would

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include foreclosed real estate, long-lived assets, and core deposit intangible assets, which are reviewed when circumstances or other events indicate that impairment may have occurred.

Valuation Methods for Instruments Measured at Fair Value on a Recurring Basis

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

Available-for-Sale Securities

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

Mortgage Servicing Rights

The fair value of mortgage servicing rights is based on the discounted value of estimated future cash flows utilizing contractual cash flows, servicing rate, constant prepayment rate, servicing cost, and discount rate factors. Accordingly, the fair value is estimated based on a valuation model that calculates the present value of estimated future net

servicing income. The model incorporates assumptions that market participants use in estimating future net servicing income, including estimates of prepayment speeds, market discount rates, cost to service, float earnings rates, and other ancillary income, including late fees. The valuation models estimate the present value of estimated future net servicing income. The Company classifies its servicing rights as Level 3.

(in thousands)	Fair Value	Fair Value Measurements		
		Quoted Prices in Active Markets for Identifiable Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
March 31, 2016				
Assets:				
Government sponsored enterprises	\$ 42,212	\$ 0	\$ 42,212	\$ 0
Asset-backed securities	175,843	0	175,843	0
Obligations of states and political subdivisions	27,718	0	27,718	0
Mortgage servicing rights	2,745	0	0	2,745
Total	\$ 248,518	\$ 0	\$ 245,773	\$ 2,745
December 31, 2015				
Assets:				
Government sponsored enterprises	\$ 73,497	\$ 0	73,497	0
Asset-backed securities	128,851	0	128,851	0
Obligations of states and political subdivisions	32,706	0	32,706	0
Mortgage servicing rights	2,847	0	0	2,847
Total	\$ 237,901	\$ 0	\$ 235,054	\$ 2,847

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The changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized as follows:

<i>(in thousands)</i>	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Mortgage Servicing Rights Three Months Ended March 31,	
	2016	2015
Balance at beginning of period	\$ 2,847	\$ 2,762
Total gains or losses (realized/unrealized):		
Included in earnings	(155)	(219)
Included in other comprehensive income	0	0
Purchases	0	0
Sales	0	0
Issues	53	119
Settlements	0	0
Balance at end of period	\$ 2,745	\$ 2,662

The change in valuation of mortgage servicing rights arising from inputs and assumptions decreased \$3,000 and \$41,000 for the three months ended March 31, 2016 and 2015, respectively.

Quantitative Information about Level 3 Fair Value Measurements		Input Value Three Months Ended March 31,		
Valuation Technique	Unobservable Inputs	2016	2015	
Mortgage servicing rights	Discounted cash flows	Weighted average constant prepayment rate	10.30 %	11.19 %

Weighted average note rate	3.91	%	3.94	%
Weighted average discount rate	9.19	%	9.26	%
Weighted average expected life (in years)	5.70		5.40	

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

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

Impaired Loans

The Company does not record loans at fair value on a recurring basis other than loans that are considered impaired. The net carrying value of impaired loans is generally based on fair values of the underlying collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. Once the fair value of the collateral has been determined and any impairment amount calculated, a specific reserve allocation is made. Because many of these inputs are not observable, the measurements are classified as Level 3. As of March 31, 2016, the Company identified \$5.2 million in impaired loans that had specific allowances for losses aggregating \$1.3 million. Related to these loans, there was \$560,000 in charge-offs recorded during the three months ended March 31, 2016. As of March 31, 2015, the Company identified \$7.7 million in impaired loans that had specific allowances for losses aggregating \$2.4 million. Related to these loans, there was \$95,000 in charge-offs recorded during the three months ended March 31, 2015.

Other Real Estate and Foreclosed Assets

Other real estate and foreclosed assets consisted of loan collateral that has been repossessed through foreclosure. This collateral is comprised of commercial and residential real estate and other non-real estate property, including autos,

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

(in thousands)	Total Fair Value	Fair Value Measurements Using			Three Months Ended March 31, Total Gains (Losses)*
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
March 31, 2016					
Assets:					
Impaired loans:					
Commercial, financial, & agricultural	\$ 248	\$ 0	\$ 0	\$ 248	\$ (359)
Real estate construction - commercial	44	0	0	44	0
Real estate mortgage - residential	3,170	0	0	3,170	(35)
Real estate mortgage - commercial	243	0	0	243	(154)
Consumer	100	0	0	100	(12)
Total	\$ 3,805	\$ 0	\$ 0	\$ 3,805	\$ (560)
Other real estate and foreclosed assets	\$ 15,471	\$ 0	\$ 0	\$ 15,471	\$ 33

March 31, 2015

Assets:

Impaired loans:

Commercial, financial, & agricultural	\$ 1,130	\$ 0	\$ 0	\$ 1,130	\$ 0
Real estate mortgage - residential	3,169	0	0	3,169	(71)
Real estate mortgage - commercial	818	0	0	818	(23)
Consumer	174	0	0	174	(1)
Total	\$ 5,291	\$ 0	\$ 0	\$ 5,291	\$ (95)
Other real estate and foreclosed assets	\$ 11,751	\$ 0	\$ 0	\$ 11,751	\$ 228

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

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Fair Value of Financial Instruments

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

Loans

The fair values of loans are estimated by discounting the expected future cash flows using the current rates at which similar loans could be made to borrowers with similar credit ratings and for the same remaining maturities. The net carrying amount of impaired loans is generally based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC Topic 820.

Investment Securities

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

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Federal Home Loan Bank (FHLB) Stock

Ownership of equity securities of FHLB is restricted and there is no established market for their resale. The carrying amount is a reasonable estimate of fair value.

Federal Funds Sold, Cash, and Due from Banks

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

Mortgage Servicing Rights

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

Cash Surrender Value - Life Insurance

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

Accrued Interest Receivable and Payable

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

Deposits

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