HAWTHORN BANCSHARES, INC.
Form 10-Q
November 16, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2015

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 incorporation or organization)	*(I.R.S. Employer Identification No.)*

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

(Address of principal executive offices) *(Zip Code)*

(573) 761-6100

(Registrant's telephone number, including area code)

N/A

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

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

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

As of November 16, 2015, the registrant had 5,443,344 shares of common stock, par value $1.00 per share, outstanding

Part I - Financial Information

Item 1. Financial Statements

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets *(unaudited)*

(In thousands, except per share data)	September 30, 2015	December 31, 2014
ASSETS		
Cash and due from banks	$ 17,664	$ 22,364
Federal funds sold and other overnight interest-bearing deposits	14,463	20,445
Cash and cash equivalents	32,127	42,809
Investment in available-for-sale securities, at fair value	244,250	198,998
Other investments and securities, at cost	9,237	4,722
Total investment securities	253,487	203,720
Loans	879,474	861,213
Allowances for loan losses	(9,246)	(9,099)
Net loans	870,228	852,114
Premises and equipment - net	36,727	37,498
Mortgage servicing rights	2,774	2,762
Other real estate and repossessed assets - net	15,148	11,885
Accrued interest receivable	4,909	4,816
Cash surrender value - life insurance	2,329	2,284
Other assets	9,895	11,843
Total assets	$ 1,227,624	$ 1,169,731
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits		
Non-interest bearing demand	$ 209,714	$ 207,700
Savings, interest checking and money market	452,878	442,059
Time deposits $100,000 and over	138,891	134,945
Other time deposits	170,685	184,810
Total deposits	972,168	969,514
Federal funds purchased and securities sold under agreements to repurchase	27,762	17,970
Subordinated notes	49,486	49,486
Federal Home Loan Bank advances	80,000	43,000
Accrued interest payable	378	373
Other liabilities	10,757	8,820
Total liabilities	1,140,551	1,089,163
Stockholders’ equity:		
Common stock, $1 par value, authorized 15,000,000 shares; issued 5,605,202 and 5,395,844 shares, respectively	5,605	5,396

Surplus	38,544	35,901
Retained earnings	46,979	44,016
Accumulated other comprehensive loss, net of tax	(538)	(1,228)
Treasury stock; 161,858 shares, at cost	(3,517)	(3,517)
Total stockholders’ equity	87,073	80,568
Total liabilities and stockholders’ equity	$ 1,227,624	$ 1,169,731

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

2

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Income *(unaudited)*

(In thousands, except per share amounts)	Three Months Ended September 30, 2015	2014	Nine Months Ended September 30, 2015	2014
INTEREST INCOME				
Interest and fees on loans	$ 10,713	$ 10,146	$ 30,891	$ 30,059
Interest on investment securities:				
Taxable	872	845	2,663	2,600
Nontaxable	169	180	524	543
Federal funds sold and other overnight interest-bearing deposits	3	5	24	23
Dividends on other securities	72	20	139	59
Total interest income	11,829	11,196	34,241	33,284
INTEREST EXPENSE				
Interest on deposits:				
Savings, interest checking and money market	241	229	738	750
Time deposit accounts $100,000 and over	222	237	653	723
Other time deposits	269	331	831	1,067
Interest on federal funds purchased and securities sold under agreements to repurchase	12	5	28	14
Interest on subordinated notes	325	318	958	945
Interest on Federal Home Loan Bank advances	202	120	513	328
Total interest expense	1,271	1,240	3,721	3,827
Net interest income	10,558	9,956	30,520	29,457
Provision for loan losses	0	0	250	0
Net interest income after provision for loan losses	10,558	9,956	30,270	29,457
NON-INTEREST INCOME				
Service charges and other fees	903	979	2,597	2,808
Bank card income and fees	632	621	1,849	1,780
Trust department income	235	211	714	641
Real estate servicing fees, net	177	86	357	285
Gain on sale of mortgage loans, net	322	330	1,103	778
Other	67	86	165	290
Total non-interest income	2,336	2,313	6,785	6,582
NON-INTEREST EXPENSE				
Salaries and employee benefits	5,320	5,582	15,798	15,573
Occupancy expense, net	685	705	2,064	1,997
Furniture and equipment expense	464	438	1,379	1,334
Processing, network, and bank card expense	806	780	2,402	2,359
Legal, examination, and professional fees	332	341	943	849
FDIC insurance assessment	175	244	673	724
Advertising and promotion	273	305	780	852
Postage, printing, and supplies	250	268	794	813

Real estate foreclosure expense and (gains), net	(329)	361	(352)	657
Other	1,001	875	2,472	2,259
Total non-interest expense	8,977	9,899	26,953	27,417
Income before income taxes	3,917	2,370	10,102	8,622
Income tax expense	1,378	802	3,497	2,969
Net income	2,539	1,568	6,605	5,653
Basic earnings per share	$ 0.47	$ 0.29	$ 1.21	$ 1.04
Diluted earnings per share	$ 0.47	$ 0.29	$ 1.21	$ 1.04

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

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income *(unaudited)*

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(In thousands)	2015	2014	2015	2014
Net income	$ 2,539	$ 1,568	$ 6,605	$ 5,653
Other comprehensive income, net of tax				
Investment securities available-for-sale:				
Unrealized gain (loss) on investment securities available-for-sale, net of tax	993	(328)	617	1,202
Adjustment for gain on sale of investment securities, net of tax	0	0	5	0
Defined benefit pension plans:				
Amortization of prior service cost included in net periodic pension cost, net of tax	24	12	68	36
Total other comprehensive income (loss)	1,017	(316)	690	1,238
Total comprehensive income	$ 3,556	$ 1,252	$ 7,295	$ 6,891

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, 2013	$ 5,195	$ 33,385	$ 40,086	$ (769)	$ (3,517)	$ 74,380
Net income	0	0	5,653	0	0	5,653
Other comprehensive income	0	0	0	1,238	0	1,238
Stock dividend	201	2,496	(2,697)	0	0	0
Stock based compensation expense	0	15	0	0	0	15
Cash dividends declared, common stock	0	0	(765)	0	0	(765)
Balance, September 30, 2014	$ 5,396	$ 35,896	$ 42,277	$ 469	$ (3,517)	$ 80,521
Balance, December 31, 2014	$ 5,396	$ 35,901	$ 44,016	$ (1,228)	$ (3,517)	$ 80,568
Net income	0	0	6,605	0	0	6,605
Other comprehensive income	0	0	0	690	0	690
Stock dividend	209	2,638	(2,847)	0	0	0
Stock based compensation expense	0	5	0	0	0	5
Cash dividends declared, common stock	0	0	(795)	0	0	(795)
Balance, September 30, 2015	$ 5,605	$ 38,544	$ 46,979	$ (538)	$ (3,517)	$ 87,073

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

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows *(unaudited)*

	Nine Months Ended September 30,	
(In thousands)	2015	2014
Cash flows from operating activities:		
Net income	$ 6,605	$ 5,653
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	250	0
Depreciation expense	1,454	1,305
Net amortization of investment securities, premiums, and discounts	1,007	809
Stock based compensation expense	5	15
Change in fair value of mortgage servicing rights	291	386
Gain on sale of investment securities	(8)	0
Gain on sales and dispositions of premises and equipment	(8)	(41)
Gain on sales and dispositions of other real estate and repossessed assets	(151)	(149)
Provision for other real estate owned	(6)	450
Increase (decrease) in accrued interest receivable	(93)	264
Increase in cash surrender value -life insurance	(45)	(56)
Decrease (increase) in other assets	2,224	(181)
Increase (decrease) in accrued interest payable	5	(44)
Increase in other liabilities	1,251	2,603
Origination of mortgage loans for sale	(40,008)	(25,576)
Proceeds from the sale of mortgage loans	40,090	25,568
Gain on sale of mortgage loans, net	(1,103)	(778)
Other, net	(194)	(377)
Net cash provided by operating activities	11,566	9,851
Cash flows from investing activities:		
Net increase in loans	(21,892)	(24,155)
Purchase of available-for-sale debt securities	(81,595)	(41,321)
Proceeds from maturities of available-for-sale debt securities	24,188	18,015
Proceeds from calls of available-for-sale debt securities	11,440	24,605
Proceeds from sales of available-for-sale debt securities	720	0
Proceeds from sales of FHLB stock	400	39
Purchases of FHLB stock	(4,915)	(440)
Purchases of premises and equipment	(709)	(1,181)
Proceeds from sales of premises and equipment	11	45
Proceeds from sales of other real estate and foreclosed assets	1,443	3,945
Net cash used in investing activities	(70,909)	(20,448)
Cash flows from financing activities:		
Net increase in demand deposits	2,014	12,898
Net increase in interest-bearing transaction accounts	10,819	14,748
Net decrease in time deposits	(10,179)	(19,412)

Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	9,792	(11,541)
Repayment of FHLB advances	(55,000)	(10,000)
FHLB advances	92,000	21,000
Cash dividends paid - common stock	(785)	(755)
Net cash provided by financing activities	48,661	6,938
Net (decrease) increase in cash and cash equivalents	(10,682)	(3,659)
Cash and cash equivalents, beginning of period	42,809	28,439
Cash and cash equivalents, end of period	$ 32,127	$ 24,780

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

6

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

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

	Nine Months Ended September 30,			
(In thousands)	2015		2014	
Supplemental disclosures of cash flow information:				
Cash paid during the year for:				
Interest	$	3,717	$	3,872
Income taxes	$	1,559	$	1,650
Noncash investing activities:				
Other real estate and repossessed assets acquired in settlement of loans	$	4,549	$	1,817

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 Lee's Summit, Missouri. The Company is subject to competition from other financial and nonfinancial institutions providing financial products. Additionally, the Company and its subsidiaries are subject to the regulations of certain regulatory agencies and undergo periodic examinations by those regulatory agencies.

The accompanying unaudited consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q, and Rule 10-01 of Regulation S-X. Accordingly, the unaudited consolidated financial statements do not include all of the information and disclosures required by U.S. GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014. Certain amounts in the 2014 condensed consolidated financial statements have been reclassified to conform to the 2014 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 2015:

Investments - Equity Method and Joint Ventures

The FASB issued ASU No. 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*, in January 2014. These amendments allow investors in low income housing tax credit entities to account for the investments using a proportional amortization method, provided that certain conditions are met, and recognize amortization of the investment as a component of income tax expense. In addition, disclosures are required that will enable users to understand the nature of the investments, and the effect of the measurement of the investments and the related tax credits on the investor's financial statements. This ASU was effective January 1, 2015, and the adoption of this pronouncement did not have a significant effect on the Company's consolidated financial statements.

Troubled Debt Restructurings by Creditors

The FASB issued ASU No. 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*, in January 2014. These amendments require companies to disclose the amount of foreclosed residential real estate property held and the recorded investment in consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements of the applicable jurisdiction. The ASU also defines when a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan. This ASU was effective January 1, 2015, and the adoption of this pronouncement did not have a significant effect on the Company's consolidated financial statements.

The FASB issued ASU No. 2014-14, *Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure* in August 2014. The objective of this update is to reduce diversity in practice by addressing the classification of foreclosed mortgage loans that are fully or partially guaranteed under government programs, including those guaranteed by the FHA and the VA. Some creditors reclassify those loans to real estate consistent with other foreclosed loans that do not have guarantees; others

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

reclassify the loans to other receivables. The amendments in this ASU require that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) The loan has a government guarantee that is not separable from the loan before foreclosure; (2) At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. This ASU was effective January 1, 2015, and the adoption of this pronouncement did not have a significant effect on the Company's consolidated financial statements.

(2) Loans and Allowance for Loan Losses

Loans

A summary of loans, by major class within the Company’s loan portfolio, at September 30, 2015 and December 31, 2014 is as follows:

(in thousands)	September 30, 2015	December 31, 2014
Commercial, financial, and agricultural	$ 173,485	$ 154,834
Real estate construction - residential	13,531	18,103
Real estate construction - commercial	32,560	48,822
Real estate mortgage - residential	249,512	247,117
Real estate mortgage - commercial	388,220	372,321
Installment and other consumer	22,166	20,016

Total loans	$ 879,474	$ 861,213

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 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 automotive vehicles. At September 30, 2015, loans with a carrying value of $396.4 million, or $330.5 million fair value, were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit.

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

Allowance for Loan Losses

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

	Three Months Ended September 30, 2015							
(in thousands)	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
Balance at beginning of period	$3,124	$ 17	$ 414	$ 2,332	$ 3,870	$ 185	$ 44	$9,986
Additions:								
Provision for loan losses	439	(27)	137	(233)	(503)	66	121	0
Deductions:								
Loans charged off	591	0	0	87	126	80	0	884
Less recoveries on loans	(28)	(28)	0	(45)	(5)	(38)	0	(144)
Net loans charged off	563	(28)	0	42	121	42	0	740
Balance at end of period	$3,000	$ 18	$ 551	$ 2,057	$ 3,246	$ 209	$ 165	$9,246

	Nine Months Ended September 30, 2015							
(in thousands)	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
Balance at beginning of period	$1,779	$ 171	$ 466	$ 2,527	$ 3,846	$ 270	$ 40	$9,099

Additions:								
Provision for loan losses	1,319	(475)	90	(277)	(598)	66	125	250
Deductions:								
Loans charged off	741	0	5	298	159	241	0	1,444
Less recoveries on loans	(643)	(322)	0	(105)	(157)	(114)	0	(1,341)
Net loans (recovered) charged off	98	(322)	5	193	2	127	0	103
Balance at end of period	$3,000	$ 18	$ 551	$ 2,057	$ 3,246	$ 209	$ 165	$9,246

10

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

	Three Months Ended September 30, 2014							
(in thousands)	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
Balance at beginning of period	$1,943	$ 473	$ 618	$ 2,405	$ 6,428	$ 274	$ 9	$12,150
Additions:								
Provision for loan losses	(188)	(94)	(96)	313	7	38	20	0
Deductions:								
Loans charged off	105	0	0	41	80	71	0	297
Less recoveries on loans	(55)	0	0	(26)	(67)	(32)	0	(180)
Net loans charged off	50	0	0	15	13	39	0	117
Balance at end of period	$1,705	$ 379	$ 522	$ 2,703	$ 6,422	$ 273	$ 29	$12,033

	Nine Months Ended September 30, 2014							
(in thousands)	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
Balance at beginning of period	$2,374	$ 931	$ 631	$ 2,959	$ 6,523	$ 294	$ 7	$13,719
Additions:								
Provision for loan losses	(660)	(553)	382	(171)	891	89	22	0
Deductions:								
Loans charged off	291	59	491	236	1,152	270	0	2,499
Less recoveries on loans	(282)	(60)	0	(151)	(160)	(160)	0	(813)
Net loans charged off	9	(1)	491	85	992	110	0	1,686
Balance at end of period	$1,705	$ 379	$ 522	$ 2,703	$ 6,422	$ 273	$ 29	$12,033

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.

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 September 30, 2015 and December 31, 2014, and the related loan balance by impairment methodology.

(in thousands)	Commercial, Financial, and Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
September 30, 2015								
Allowance for loan losses:								
Individually evaluated for impairment	$ 305	$ 0	$ 8	$ 1,178	$ 459	$ 20	$ 0	$ 1,970
Collectively evaluated for impairment	2,695	18	543	879	2,787	189	165	7,276
Total	$ 3,000	$ 18	$ 551	$ 2,057	$ 3,246	$ 209	$ 165	$ 9,246
Loans outstanding:								
Individually evaluated for impairment	$ 3,643	$ 0	$ 54	$ 6,891	$ 3,481	$ 141	$ 0	$ 14,210
Collectively evaluated for impairment	169,842	13,531	32,506	242,621	384,739	22,025	0	865,264
Total	$ 173,485	$ 13,531	$ 32,560	$ 249,512	$ 388,220	$ 22,166	$ 0	$ 879,474
December 31, 2014								
Allowance for loan losses:								
Individually evaluated for impairment	$ 134	$ 0	$ 0	$ 1,343	$ 246	$ 26	$ 0	$ 1,749
Collectively evaluated for impairment	1,645	171	466	1,184	3,600	244	40	7,350
Total	$ 1,779	$ 171	$ 466	$ 2,527	$ 3,846	$ 270	$ 40	$ 9,099

Loans outstanding:								
Individually evaluated for impairment	$ 7,541	$ 1,750	$ 2,096	$ 7,878	$ 16,464	$ 234	$ 0	$ 35,963
Collectively evaluated for impairment	147,293	16,353	46,726	239,239	355,857	19,782	0	825,250
Total	$ 154,834	$ 18,103	$ 48,822	$ 247,117	$ 372,321	$ 20,016	$ 0	$ 861,213

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 $14.2 million and $36.0 million at September 30, 2015 and December 31, 2014, 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 based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At September 30, 2015 and December 31, 2014, $11.9 million and $15.6 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 September 30, 2015, $2.0 million of the Company’s allowance for loan losses was allocated to impaired loans totaling $14.2 million compared to $1.7 million of the Company's allowance for loan losses allocated to impaired loans totaling approximately $36.0 million at December 31, 2014. Management determined that $7.4 million, or 52%, of total impaired loans required no reserve allocation at September 30, 2015 compared to $28.5 million, or 79%, at December 31, 2014 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

The categories of impaired loans at September 30, 2015 and December 31, 2014 are as follows:

(in thousands)	September 30, 2015	December 31, 2014
Non-accrual loans	$ 8,957	$ 18,243
Troubled debt restructurings continuing to accrue interest	5,253	17,720
Total impaired loans	$ 14,210	$ 35,963

The following tables provide additional information about impaired loans at September 30, 2015 and December 31, 2014, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided.

(in thousands)	Recorded Investment	Unpaid Principal Balance	Specific Reserves
September 30, 2015			
With no related allowance recorded:			
Commercial, financial and agricultural	$ 2,877	$ 3,403	$ 0
Real estate - construction residential	0	0	0
Real estate - construction commercial	0	0	0
Real estate - residential	2,095	2,532	0
Real estate - commercial	2,450	2,579	0
Total	$ 7,422	$ 8,514	$ 0
With an allowance recorded:			
Commercial, financial and agricultural	$ 766	$ 778	$ 305
Real estate - construction commercial	54	56	8
Real estate - residential	4,796	4,928	1,178
Real estate - commercial	1,031	1,315	459

Consumer	141	176	20
Total	$ 6,788	$ 7,253	$ 1,970
Total impaired loans	$ 14,210	$ 15,767	$ 1,970

(in thousands)	Recorded Investment	Unpaid Principal Balance	Specific Reserves
December 31, 2014			
With no related allowance recorded:			
Commercial, financial and agricultural	$ 6,021	$ 6,232	$ 0
Real estate - construction residential	1,750	2,259	0
Real estate - construction commercial	2,096	2,319	0
Real estate - residential	3,213	3,270	0
Real estate - commercial	15,409	18,950	0
Consumer	36	36	0
Total	$ 28,525	$ 33,066	$ 0
With an allowance recorded:			
Commercial, financial and agricultural	$ 1,520	$ 1,528	$ 134
Real estate - construction residential	0	0	0
Real estate - construction commercial	0	0	0
Real estate - residential	4,665	3,546	1,343
Real estate - commercial	1,055	1,171	246
Consumer	198	237	26
Total	$ 7,438	$ 6,482	$ 1,749
Total impaired loans	$ 35,963	$ 39,548	$ 1,749

13

Hawthorn Bancshares, Inc.

and subsidiaries

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 September 30,				Nine Months Ended September 30,			
	2015		2014		2015		2014	
(in thousands)	Average Recorded Investment	Interest Recognized For the Period Ended	Average Recorded Investment	Interest Recognized For the Period Ended	Average Recorded Investment	Interest Recognized For the Period Ended	Average Recorded Investment	Interest Recognized For the Period Ended
With no related allowance recorded:								
Commercial, financial and agricultural	$ 3,416	$ 6	$ 2,618	$ 22	$ 4,033	$ 33	$ 2,592	$ 69
Real estate - construction residential	0	0	16	2	1,101	0	65	2
Real estate - construction commercial	0	0	6,524	0	2,002	0	6,737	0
Real estate - residential	2,326	5	3,941	26	2,924	26	3,374	40
Real estate - commercial	2,958	17	12,578	84	8,978	103	12,334	255
Consumer	0	0	0	0	10	1	11	0
Total	$ 8,700	$ 28	$ 25,677	$ 134	$ 19,048	$ 163	$ 25,113	$ 366
With an allowance recorded:								
Commercial, financial and agricultural	$ 787	$ 5	$ 1,940	$ 4	$ 1,389	$ 18	$ 2,128	$ 19
Real estate - construction residential	0	0	2,260	0	0	0	2,263	0
Real estate - construction commercial	55	0	0	0	28	0	56	93
Real estate - residential	4,850	30	5,458	0	4,713	80	5,384	11

Real estate - commercial	1,228	0	4,587	28	1,216	0	4,695	0
Consumer	162	0	310	11	209	0	324	0
Total	$ 7,082	$ 35	$ 14,555	$ 43	$ 7,555	$ 98	$ 14,850	$ 123
Total impaired loans	$ 15,782	$ 63	$ 40,232	$ 177	$ 26,603	$ 261	$ 39,963	$ 489

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 $63,000 and $261,000, for the three months and nine months ended September 30, 2015, respectively, compared to $177,000 and $489,000 for the three and nine months ended September 30, 2014, 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.

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

The following table provides aging information for the Company's past due and non-accrual loans at September 30, 2015 and December 31, 2014.

(in thousands)	Current or Less Than 30 Days Past Due	30 - 89 Days Past Due	90 Days Past Due And Still Accruing	Non-Accrual	Total
September 30, 2015					
Commercial, Financial, and Agricultural	$170,230	$424	$ 0	$ 2,831	$173,485
Real Estate Construction - Residential	13,459	72	0	0	13,531
Real Estate Construction - Commercial	32,447	59	0	54	32,560
Real Estate Mortgage - Residential	244,144	1,431	348	3,589	249,512
Real Estate Mortgage - Commercial	385,253	625	0	2,342	388,220
Installment and Other Consumer	21,794	230	1	141	22,166
Total	$867,327	$2,841	$ 349	$ 8,957	$879,474
December 31, 2014					
Commercial, Financial, and Agricultural	$149,366	$189	$ 0	$ 5,279	$154,834
Real Estate Construction - Residential	16,352	0	0	1,751	18,103
Real Estate Construction - Commercial	46,670	0	56	2,096	48,822
Real Estate Mortgage - Residential	239,469	3,229	0	4,419	247,117
Real Estate Mortgage - Commercial	366,653	1,203	0	4,465	372,321
Installment and Other Consumer	19,551	230	2	233	20,016
Total	$838,061	$4,851	$ 58	$ 18,243	$861,213

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.

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

The following table presents the risk categories by class at September 30, 2015 and December 31, 2014.

(in thousands)	**Commercial, Financial, & Agricultural**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment and other Consumer**	Total
At September 30, 2015							
Watch	$ 12,500	1,249	$ 1,146	$ 27,451	$ 28,987	$ 193	$71,526
Substandard	332	0	98	2,841	2,577	38	5,886
Performing TDRs	812	0	0	3,302	1,139	0	5,253
Non-accrual	2,831	0	54	3,589	2,342	141	8,957
Total	$ 16,475	$ 1,249	$ 1,298	$ 37,183	$ 35,045	$ 372	$91,622
At December 31, 2014							
Watch	$ 13,651	$ 1,103	$ 4,757	$ 27,172	$ 18,191	$ 199	$65,073
Substandard	926	90	1,211	3,124	4,102	139	9,592
Performing TDRs	2,262	0	0	3,459	11,999	0	17,720
Non-accrual	5,279	1,751	2,096	4,419	4,465	233	18,243
Total	$ 22,118	$ 2,944	$ 8,064	$ 38,174	$ 38,757	$ 571	$110,628

Troubled Debt Restructurings

At September 30, 2015, loans classified as TDRs totaled $6.7 million, of which $1.4 million were classified as nonperforming TDRs and included in non-accrual loans and $5.3 million were classified as performing TDRs. At December 31, 2014, TDRs totaled $19.3 million, of which $1.6 million were classified as nonperforming TDRs included in non-accrual loans and $17.7 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 $1.2 million and $1.0 million related to TDRs were allocated to the allowance for loan losses at September 30, 2015 and December 31, 2014, respectively.

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

	Nine Months Ended September 30,					
	2015			2014		
		Recorded Investment (1)			Recorded Investment (1)	
(in thousands)	**Number of Contracts**	**Pre-Modification**	**Post-Modification**	**Number of Contracts**	**Pre-Modification**	**Post-Modification**
Troubled Debt Restructurings						
Commercial, financial and agricultural	3	$ 250	$ 240	3	$ 244	$ 225
Real estate mortgage - residential	3	510	352	1	1,256	1,171
Real estate mortgage - commercial	4	1,273	1,263	0	0	0
Total	10	$ 2,033	$ 1,855	4	$ 1,500	$ 1,396

(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 due to deteriorated financial condition such as interest rates below the current market rate, deferring principal payments, and extending maturity dates. There were no modified loans that met the TDR criteria during the three months ended September 30, 2015 and 2014. During the nine months ended September 30, 2015, ten loans meeting the TDR criteria were modified compared to four loans during the nine months ended September 30, 2014.

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

Upon default of a TDR, which is considered to be 90 days or more past due under the modified terms, impairment is measured based on the fair value of the underlying collateral less applicable selling costs. The impairment amount is either charged off as a reduction to the allowance for loan losses, provided for as a specific reserve within the allowance for loan losses, or in the process of foreclosure. There were no TDRs that defaulted within twelve months of its modification date during the three and nine months ended September 30, 2015 and 2014, respectively.

(3) Other Real Estate and Repossessed Assets

(in thousands)	September 30, 2015	December 31, 2014
Commercial, financial and agricultural	$ 585	$ 0
Real estate construction - residential	0	23
Real estate construction - commercial	12,380	9,831
Real estate mortgage - residential	483	417
Real estate mortgage - commercial	4,923	4,831
Repossessed assets	10	38
Total	$ 18,381	$ 15,140
Less valuation allowance for other real estate owned	(3,233)	(3,255)
Total other real estate and repossessed assets	$ 15,148	$ 11,885

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014

Balance at beginning of period	$ 15,749	$ 15,231	$ 15,140	$ 19,542
Additions	3,032	1,512	4,549	1,817
Proceeds from sales	(407)	(821)	(1,443)	(3,945)
Charge-offs against the valuation allowance for other real estate owned	0	(199)	(16)	(1,843)
Repossessed assets impairment write-downs	0	0	0	0
Net gain (loss) on sales	7	(3)	151	149
Total other real estate and repossessed assets	$ 18,381	$ 15,720	$ 18,381	$ 15,720
Less valuation allowance for other real estate owned	(3,233)	(3,282)	(3,233)	(3,282)
Balance at end of period	$ 15,148	$ 12,438	$ 15,148	$ 12,438

Net charge-offs against the allowance for loan losses at the time of foreclosure were approximately $180,000 and $323,000 during the three and nine months ended September 30, 2015, respectively, compared to $51,000 and $280,000 during the three and nine months ended September 30, 2014, respectively.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	2015	2014	2015	2014
Balance, beginning of period	$ 3,233	$ 3,205	$ 3,255	$ 4,675
Provision for other real estate owned	0	276	(6)	450
Charge-offs	0	(199)	(16)	(1,843)
Balance, end of period	$ 3,233	$ 3,282	$ 3,233	$ 3,282

17

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(4) Investment Securities

The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2015 and December 31, 2014 were as follows:

(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair value
September 30, 2015				
Government sponsored enterprises	$ 87,618	$ 444	$ 12	88,050
Asset-backed securities	122,348	1,046	668	122,726
Obligations of states and political subdivisions	32,935	555	16	