

HAWTHORN BANCSHARES, INC.  
Form 10-Q  
November 09, 2010

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2010**

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

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

**300 Southwest Longview Boulevard, Lees Summit, Missouri 64081**  
(Address of principal executive offices) (Zip Code)

**(816) 347-8100**  
(Registrant's telephone number, including area code)

**N/A**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  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       Smaller reporting company

(Do not check if a smaller reporting company)

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

As of November 9, 2010 the registrant had 4,474,033 shares of common stock, par value \$1.00 per share, outstanding.

## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

## HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets (Unaudited)

|  | September 30,<br>2010   | December 31,<br>2009    |
|--|-------------------------|-------------------------|
| <b>ASSETS</b>  |                         |                         |
| Loans  | \$ 933,456,302          | \$ 991,614,007          |
| Allowances for loan losses   | (13,953,687)            | (14,796,549)            |
| <b>Net loans</b>   | <b>919,502,615</b>      | <b>976,817,458</b>      |
| Investment in available-for-sale securities, at fair value                 | 165,172,611             | 152,926,685             |
| Federal funds sold and securities purchased under agreements to resell     | 125,820                 | 89,752                  |
| Cash and due from banks  | 52,099,695              | 24,575,943              |
| Premises and equipment net   | 37,236,395              | 38,623,293              |
| Other real estate owned and repossessed assets                             | 10,012,412              | 8,490,914               |
| Accrued interest receivable  | 6,020,411               | 6,625,557               |
| Mortgage servicing rights  | 2,198,887               | 2,020,964               |
| Intangible assets net  | 1,095,535               | 1,503,986               |
| Cash surrender value life insurance  | 1,979,466               | 1,929,910               |
| Other assets   | 19,622,328              | 22,866,092              |
| <b>Total assets</b>  | <b>\$ 1,215,066,175</b> | <b>\$ 1,236,470,554</b> |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                                 |                         |                         |
| Deposits:  |                         |                         |
| Non-interest bearing demand  | \$ 143,143,196          | \$ 135,017,639          |
| Savings, interest checking and money market                                | 363,916,607             | 354,284,004             |
| Time deposits \$100,000 and over   | 127,609,669             | 137,860,435             |
| Other time deposits  | 315,904,482             | 329,160,719             |
| <b>Total deposits</b>  | <b>950,573,954</b>      | <b>956,322,797</b>      |
| Federal funds purchased and securities sold under agreements to repurchase | 31,460,010              | 36,645,434              |
| Subordinated notes   | 49,486,000              | 49,486,000              |
| Other borrowed money   | 67,168,047              | 79,317,302              |
| Accrued interest payable   | 1,344,701               | 2,438,121               |
| Other liabilities  | 5,112,064               | 4,489,617               |
| <b>Total liabilities</b>   | <b>1,105,144,776</b>    | <b>1,128,699,271</b>    |
| Stockholders equity:   |                         |                         |
| Preferred stock, \$1,000 par value   |                         |                         |
| Authorized and issued 30,255 shares  | 28,722,124              | 28,364,768              |
| Common stock, \$1 par value  |                         |                         |

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|  |                  |                  |
|--|------------------|------------------|
| Authorized 15,000,000 shares; issued 4,635,891 and 4,463,813 shares,<br>respectively | 4,635,891        | 4,463,813        |
| Surplus  | 28,909,244       | 26,970,745       |
| Retained earnings  | 48,828,486       | 50,576,551       |
| Accumulated other comprehensive income, net of tax                                   | 2,342,472        | 912,224          |
| Treasury stock; 161,858 shares, at cost  | (3,516,818)      | (3,516,818)      |
| <b>Total stockholders equity</b>   | 109,921,399      | 107,771,283      |
| <b>Total liabilities and stockholders equity</b>                                     | \$ 1,215,066,175 | \$ 1,236,470,554 |

See accompanying notes to consolidated financial statements.

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

|  | <b>For the Three Months<br/>Ended<br/>September 30,</b> |                   | <b>For the Nine Months Ended<br/>September 30,</b> |                   |
|--|---|-------------------|--|-------------------|
|  | <b>2010</b>   | <b>2009</b>       | <b>2010</b>  | <b>2009</b>       |
| <b>INTEREST INCOME</b>   |   |                   |  |                   |
| Interest and fees on loans   | \$ 13,234,729   | \$ 14,340,996     | \$ 40,286,802                                      | \$ 43,332,581     |
| Interest on debt securities:   |   |                   |  |                   |
| Taxable  | 1,054,667   | 1,152,935         | 3,236,744  | 3,430,153         |
| Nontaxable   | 273,538   | 350,839           | 894,293  | 1,088,561         |
| Interest on federal funds sold and securities<br>purchased under agreements to resell        | 50  | 60                | 133  | 253               |
| Interest on interest-bearing deposits  | 27,851  | 11,556            | 63,373   | 43,565            |
| Dividends on other securities  | 33,577  | 53,742            | 119,024  | 110,010           |
| <b>Total interest income</b>   | <b>14,624,412</b>                                       | <b>15,910,128</b> | <b>44,600,369</b>                                  | <b>48,005,123</b> |
| <b>INTEREST EXPENSE</b>  |   |                   |  |                   |
| Interest on deposits:  |   |                   |  |                   |
| Savings, interest checking and money market  | 511,442   | 693,242           | 1,696,648  | 2,390,089         |
| Time deposit accounts \$100,000 and over   | 594,334   | 949,273           | 1,956,968  | 3,056,793         |
| Other time deposit accounts  | 1,758,850   | 2,532,085         | 5,607,583  | 8,311,234         |
| Interest on federal funds purchased and<br>securities sold under agreements to<br>repurchase | 19,690  | 23,458            | 59,353   | 64,028            |
| Interest on subordinated notes   | 353,536   | 588,554           | 1,201,082  | 1,878,657         |
| Interest on other borrowed money   | 527,818   | 687,535           | 1,794,832  | 2,320,481         |
| <b>Total interest expense</b>  | <b>3,765,670</b>  | <b>5,474,147</b>  | <b>12,316,466</b>                                  | <b>18,021,282</b> |
| <b>Net interest income</b>   | <b>10,858,742</b>                                       | <b>10,435,981</b> | <b>32,283,903</b>                                  | <b>29,983,841</b> |
| Provision for loan losses  | 2,450,000   | 1,250,000         | 7,105,000  | 4,404,000         |
| <b>Net interest income after provision for loan<br/>losses</b>                               | <b>8,408,742</b>  | <b>9,185,981</b>  | <b>25,178,903</b>                                  | <b>25,579,841</b> |
| <b>NON-INTEREST INCOME</b>   |   |                   |  |                   |
| Service charges on deposit accounts  | 1,427,130   | 1,547,038         | 4,150,420  | 4,380,248         |
| Trust department income  | 186,989   | 237,939           | 566,495  | 623,258           |
| Gain on sale of mortgage loans, net  | 1,011,253   | 489,069           | 1,533,027  | 2,437,169         |
| Other  | 284,932   | 326,560           | 1,115,838  | 732,189           |
| <b>Total non-interest income</b>   | <b>2,910,304</b>  | <b>2,600,606</b>  | <b>7,365,780</b>                                   | <b>8,172,864</b>  |
| <b>NON-INTEREST EXPENSE</b>  |   |                   |  |                   |
| Salaries and employee benefits   | 4,256,523   | 4,454,183         | 13,463,964   | 13,403,853        |

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|  |                   |                     |                     |                     |
|--|-------------------|---------------------|---------------------|---------------------|
| Occupancy expense, net                             | 654,687           | 599,555             | 1,881,093           | 1,762,990           |
| Furniture and equipment expense                    | 472,657           | 506,469             | 1,499,307           | 1,794,400           |
| FDIC insurance assessment                          | 442,965           | 421,690             | 1,288,163           | 2,085,472           |
| Legal, examination, and professional fees          | 348,792           | 311,780             | 932,115             | 985,274             |
| Advertising and promotion                          | 311,219           | 301,348             | 886,242             | 901,066             |
| Postage, printing, and supplies                    | 299,997           | 271,434             | 874,353             | 833,846             |
| Processing expense                                 | 853,710           | 845,288             | 2,560,570           | 2,538,067           |
| Other real estate expense                          | 882,264           | 239,747             | 2,895,010           | 575,008             |
| Other  | 842,703           | 1,088,245           | 2,535,084           | 2,815,972           |
| <b>Total non-interest expense</b>                  | <b>9,365,517</b>  | <b>9,039,739</b>    | <b>28,815,901</b>   | <b>27,695,948</b>   |
| Income before income taxes                         | 1,953,529         | 2,746,848           | 3,728,782           | 6,056,757           |
| Less income taxes                                  | 531,327           | 840,070             | 1,030,346           | 1,889,060           |
| <b>Net income</b>                                  | <b>1,422,202</b>  | <b>1,906,778</b>    | <b>2,698,436</b>    | <b>4,167,697</b>    |
| Preferred stock dividends                          | 378,187           | 378,187             | 1,130,360           | 1,134,562           |
| Accretion of discount on preferred stock           | 119,119           | 119,119             | 357,356             | 357,356             |
| <b>Net income available to common shareholders</b> | <b>\$ 924,896</b> | <b>\$ 1,409,472</b> | <b>\$ 1,210,720</b> | <b>\$ 2,675,779</b> |
| Basic earnings per share                           | \$ 0.21           | \$ 0.32             | \$ 0.27             | \$ 0.60             |
| Diluted earnings per share                         | \$ 0.21           | \$ 0.32             | \$ 0.27             | \$ 0.60             |

See accompanying notes to consolidated financial statements.

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

|  | Preferred<br>Stock   | Common<br>Stock     | Surplus              | Retained<br>Earnings | Accumulated<br>other<br>Comprehensive<br>Income<br>(Loss) | Treasury<br>Stock     | Total<br>Stock -<br>holders<br>Equity |
|--|----------------------|---------------------|----------------------|----------------------|---|-----------------------|---------------------------------------|
| <b>Balance,<br/>December 31,<br/>2009</b>  | <b>\$ 28,364,768</b> | <b>\$ 4,463,813</b> | <b>\$ 26,970,745</b> | <b>\$ 50,576,551</b> | <b>\$ 912,224</b>   | <b>\$ (3,516,818)</b> | <b>\$ 107,771,283</b>                 |
| Net income   |                      |                     |                      | 2,698,436            |   |                       | 2,698,436                             |
| Change in<br>unrealized gain<br>(loss) on<br>securities:<br>Unrealized gain<br>on debt and equity<br>securities<br>available-for-sale,<br>net of tax |                      |                     |                      |                      | 1,394,275   |                       | 1,394,275                             |
| Defined benefit<br>pension plans:<br>Amortization of<br>prior service cost<br>included in net<br>periodic pension<br>cost, net of tax                |                      |                     |                      |                      | 35,973  |                       | 35,973                                |
| Total other<br>comprehensive<br>income   |                      |                     |                      |                      |   |                       | 1,430,248                             |
| Total<br>comprehensive<br>income   |                      |                     |                      |                      |   |                       | 4,128,684                             |
| Stock based<br>compensation<br>expense   |                      |                     | 68,009               |                      |   |                       | 68,009                                |
| Accretion of<br>preferred stock<br>discount  | 357,356              |                     |                      | (357,356)            |   |                       |                                       |
| Stock dividend   |                      | 172,078             | 1,870,490            | (2,042,568)          |   |                       |                                       |
| Cash dividends<br>declared, preferred<br>stock   |                      |                     |                      | (1,134,562)          |   |                       | (1,134,562)                           |

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|  |                      |                     |                      |                      |                     |                       |                       |
|--|----------------------|---------------------|----------------------|----------------------|---------------------|-----------------------|-----------------------|
| Cash dividends declared, common stock  |                      |                     |                      | (912,015)            |                     |                       | (912,015)             |
| <b>Balance, September 30, 2010</b>   | <b>\$ 28,722,124</b> | <b>\$ 4,635,891</b> | <b>\$ 28,909,244</b> | <b>\$ 48,828,486</b> | <b>\$ 2,342,472</b> | <b>\$ (3,516,818)</b> | <b>\$ 109,921,399</b> |
| <b>Balance, December 31, 2008</b>  | <b>\$ 27,888,294</b> | <b>\$ 4,298,353</b> | <b>\$ 25,144,323</b> | <b>\$ 51,598,678</b> | <b>\$ 1,005,553</b> | <b>\$ (3,516,818)</b> | <b>\$ 106,418,383</b> |
| Net income   |                      |                     |                      | 4,167,697            |                     |                       | 4,167,697             |
| Change in unrealized gain (loss) on securities:                                      |                      |                     |                      |                      |                     |                       |                       |
| Unrealized loss on debt and equity securities available-for-sale, net of tax         |                      |                     |                      |                      | 558,218             |                       | 558,218               |
| Defined benefit pension plans:   |                      |                     |                      |                      |                     |                       |                       |
| Amortization of prior service cost included in net periodic pension cost, net of tax |                      |                     |                      |                      | 36,142              |                       | 36,142                |
| Total other comprehensive loss   |                      |                     |                      |                      |                     |                       | 594,360               |
| Total comprehensive income   |                      |                     |                      |                      |                     |                       | 4,762,057             |
| Stock based compensation expense   |                      |                     | 99,697               |                      |                     |                       | 99,697                |
| Accretion of preferred stock discount  | 357,355              |                     |                      | (357,355)            |                     |                       |                       |
| Stock dividend   |                      | 165,460             | 1,695,963            | (1,861,423)          |                     |                       |                       |
| Cash dividends declared, preferred stock   |                      |                     |                      | (991,691)            |                     |                       | (991,691)             |
|  |                      |                     |                      | (1,796,893)          |                     |                       | (1,796,893)           |

Cash dividends  
declared, common  
stock

**Balance,  
September 30,  
2009**

**\$ 28,245,649 \$ 4,463,813 \$ 26,939,983 \$ 50,759,013 \$ 1,599,913 \$ (3,516,818) \$ 108,491,553**

See accompanying notes to consolidated financial statements.

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**Consolidated Statements of Cash Flows** *(Unaudited)*

|   | <b>Nine months Ended September</b> |                     |
|---|------------------------------------|---------------------|
|   | <b>2010</b>                        | <b>30,<br/>2009</b> |
| <b>Cash flows from operating activities:</b>  |                                    |                     |
| Net income  | \$ 2,698,436                       | \$ 4,167,697        |
| Adjustments to reconcile net income to net cash provided by operating activities:                     |                                    |                     |
| Provision for loan losses   | 7,105,000                          | 4,404,000           |
| Depreciation expense  | 1,484,686                          | 1,540,942           |
| Net amortization of debt securities, premiums, and discounts  | 454,671                            | 366,383             |
| Amortization of intangible assets   | 408,451                            | 475,592             |
| Stock based compensation expense  | 68,009                             | 99,697              |
| Loss on sales and dispositions of premises and equipment  | 59,621                             | 147,166             |
| Other real estate owned impairment charges  | 1,595,638                          | 62,535              |
| Decrease in deferred tax asset, net   | 728,912                            | 380,001             |
| Decrease in accrued interest receivable   | 605,146                            | 598,071             |
| Increase in cash surrender value -life insurance  | (49,556)                           | (57,750)            |
| Decrease in other assets  | 578,938                            | 93,894              |
| Decrease in accrued interest payable  | (1,093,420)                        | (1,455,466)         |
| Increase in other liabilities   | 871,960                            | 1,808,432           |
| Origination of mortgage loans held for sale   | (72,437,349)                       | (125,186,177)       |
| Proceeds from the sale of mortgage loans held for sale  | 69,193,376                         | 127,623,346         |
| Gain on sale of mortgage loans, net   | (1,533,027)                        | (2,437,169)         |
| Other, net  | 398,872                            | 371,107             |
| <b>Net cash provided by operating activities</b>  | <b>11,138,364</b>                  | <b>13,002,301</b>   |
| <b>Cash flows from investing activities:</b>  |                                    |                     |
| Net decrease in loans   | 42,321,380                         | 6,768,359           |
| Purchase of available-for-sale debt securities  | (154,204,703)                      | (110,865,517)       |
| Proceeds from maturities of available-for-sale debt securities  | 105,724,703                        | 83,996,365          |
| Proceeds from calls of available-for-sale debt securities   | 38,065,100                         | 17,805,000          |
| Proceeds from sales of FHLB stock   | 995,600                            |                     |
| Purchases of premises and equipment   | (320,967)                          | (420,575)           |
| Proceeds from sales of premises and equipment   | 34,528                             | 582,816             |
| Proceeds from sales of other real estate owned and repossessions                                      | 9,185,427                          | 1,929,955           |
| <b>Net cash provided (used) by investing activities</b>   | <b>41,801,068</b>                  | <b>(203,597)</b>    |
| <b>Cash flows from financing activities:</b>  |                                    |                     |
| Net increase in non-interest-bearing demand deposits  | 8,125,557                          | 871,554             |
| Net increase in savings, interest checking, and money market accounts                                 | 9,632,603                          | 15,278,667          |
| Net decrease in time deposits   | (23,507,003)                       | (3,311,738)         |
| Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase | (5,185,424)                        | 3,235,954           |
| Proceeds from other borrowed money  | 10,000,000                         |                     |

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|  |                      |                      |
|--|----------------------|----------------------|
| Repayment of other borrowed money                    | (22,149,255)         | (57,576,317)         |
| Cash dividends paid preferred stock                  | (1,134,562)          | (991,691)            |
| Cash dividends paid common stock                     | (1,161,528)          | (2,192,342)          |
| <b>Net cash used by financing activities</b>         | <b>(25,379,612)</b>  | <b>(44,685,913)</b>  |
| Net increase (decrease) in cash and cash equivalents | 27,559,820           | (31,887,209)         |
| Cash and cash equivalents, beginning of year         | 24,665,695           | 53,827,468           |
| <b>Cash and cash equivalents, end of period</b>      | <b>\$ 52,225,515</b> | <b>\$ 21,940,259</b> |

**Supplemental disclosures of cash flow information:**

Cash paid during the year for:

|              |               |               |
|--------------|---------------|---------------|
| Interest     | \$ 13,409,886 | \$ 19,476,748 |
| Income taxes | 200,000       | 390,000       |

**Supplemental schedule of noncash investing and financing activities:**

|   |               |              |
|---|---------------|--------------|
| Other real estate and repossessions acquired in settlement of loans | \$ 12,665,463 | \$ 5,739,740 |
| See accompanying notes to consolidated financial statements.        |               |              |

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

**Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements include all adjustments that, in the opinion of management, are necessary in order to make those statements not misleading. Management is required to make estimates and assumptions, including the determination of the allowance for loan losses, real estate acquired in connection with foreclosure or in satisfaction of loans, and fair values of 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. Operating results for the three and nine-month periods ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. Our Company's management has evaluated and did not identify any subsequent events or transactions requiring recognition or disclosure in the consolidated financial statements.

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

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

On July 1, 2010, our Company paid a special stock dividend of four percent to common shareholders of record at the close of business on May 19, 2010. For all periods presented, share information, including basic and diluted earnings per share, have been adjusted retroactively to reflect this change.

**Loans and Allowance for Loan Losses**

Major classifications in our Company's loan portfolio at September 30, 2010 and December 31, 2009 are as follows:

|  | September 30,<br>2010 | December 31,<br>2009  |
|--|-----------------------|-----------------------|
| Commercial, financial, and agricultural          | \$ 132,919,752        | \$ 151,399,300        |
| Real estate construction residential             | 38,229,395            | 38,840,664            |
| Real estate construction commercial              | 76,586,537            | 77,936,569            |
| Real estate mortgage residential                 | 217,802,375           | 232,332,124           |
| Real estate mortgage commercial                  | 433,930,074           | 453,975,271           |
| Installment loans to individuals                 | 33,821,909            | 36,966,018            |
| Unamortized loan origination fees and costs, net | 166,260               | 164,061               |
| <b>Total loans</b>                               | <b>\$ 933,456,302</b> | <b>\$ 991,614,007</b> |

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



As shown in the above table, our Company's total loans have declined \$58,158,000, or 5.9%, since December 31, 2009. Of this decline \$8,466,000 represents loans charged-off and \$12,665,000 represents loans that were foreclosed on and moved to other real estate owned and repossessed assets. Of the remaining \$37,027,000 decrease, \$21,400,000 represents payoffs/paydowns of six large credits.

A summary of impaired loans as of September 30, 2010 and December 31, 2009 is as follows:

|   | <b>September 30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|---|-------------------------------|------------------------------|
| Loans classified as impaired:   |                               |                              |
| Non-accrual loans   | \$ 49,847,089                 | \$ 34,153,731                |
| Impaired loans continuing to accrue interest                          | 16,635,933                    | 39,713,014                   |
| <b>Total impaired loans</b>   | <b>\$ 66,483,022</b>          | <b>\$ 73,866,745</b>         |
| Balance of impaired loans with reserves                               | \$ 34,715,944                 | \$ 26,294,560                |
| Balance of impaired loans without reserves                            | 31,767,078                    | 47,572,185                   |
| <b>Total impaired loans</b>   | <b>\$ 66,483,022</b>          | <b>\$ 73,866,745</b>         |
| Reserves for impaired loans   | \$ 7,797,557                  | \$ 6,414,729                 |
| Average balance of impaired loans during the period                   | 64,700,592                    | 39,048,298                   |
| Balance of trouble debt restructured loans included in impaired loans | 22,457,385                    | 11,233,326                   |

The table above shows our Company's investment in impaired loans at September 30, 2010 and December 31, 2009. These loans consist of loans on non-accrual status and other restructured loans whose terms have been modified and classified as troubled debt restructurings. Although our non-accrual loans significantly increased from \$34,153,731 at December 31, 2009 to \$49,847,089 at September 30, 2010, total impaired loans decreased \$7,383,723. The balance of impaired loans without reserves was 48% of total impaired loans at September 30, 2010 and 64% at December 31, 2009. Management believes the excess value in the collateral was sufficient at September 30, and December 31, and these loans did not require additional reserves.

The following is a summary of the allowance for loan losses for the three and nine-months ended September 30, 2010:

|                                       | <b>Three Months Ended<br/>September 30,</b> |                  | <b>Nine Months Ended September<br/>30,</b> |                  |
|---------------------------------------|---|------------------|--|------------------|
|                                       | <b>2010</b>                                 | <b>2009</b>      | <b>2010</b>                                | <b>2009</b>      |
| <b>Balance at beginning of period</b> | \$ 12,231,596                               | \$ 13,704,736    | \$ 14,796,549                              | \$ 12,666,546    |
| Additions:                            |   |                  |  |                  |
| Provision for loan losses             | 2,450,000                                   | 1,250,000        | 7,105,000                                  | 4,404,000        |
| <b>Total additions</b>                | <b>2,450,000</b>                            | <b>1,250,000</b> | <b>7,105,000</b>                           | <b>4,404,000</b> |
| Deductions:                           |   |                  |  |                  |
| Loans charged off                     | 899,795                                     | 1,198,165        | 8,466,456                                  | 3,549,572        |
| Less recoveries on loans              | (171,886)                                   | (170,963)        | (518,594)                                  | (406,560)        |

|                                 |               |               |               |               |
|---------------------------------|---------------|---------------|---------------|---------------|
| <b>Net loans charged off</b>    | 727,909       | 1,027,202     | 7,947,862     | 3,143,012     |
| <b>Balance at end of period</b> | \$ 13,953,687 | \$ 13,927,534 | \$ 13,953,687 | \$ 13,927,534 |

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**Investment Securities**

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

|  | <b>September 30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|-------------------------------|------------------------------|
| U.S. treasury                                    | \$ 1,040,234                  | \$                           |
| Government sponsored enterprises                 | 46,898,658                    | 44,380,798                   |
| Asset-backed securities                          | 85,822,384                    | 69,434,650                   |
| Obligations of states and political subdivisions | 31,411,335                    | 39,111,237                   |
| <b>Total available for sale securities</b>       | <b>\$ 165,172,611</b>         | <b>\$ 152,926,685</b>        |

Most of our Company's investment securities are classified as available for sale, as discussed in more detail below. Asset backed securities include agency mortgage-backed securities, which are guaranteed by government sponsored agencies such as the FHLMC, FNMA and GNMA. Our Company does not invest in subprime originated mortgage-backed or collateralized debt obligation instruments. Investment securities which are classified as restricted equity securities primarily consist of Federal Home Loan Bank Stock and our Company's interest in statutory trusts. These securities are reported at cost in other assets in the amount of \$6,150,250 and \$6,753,550, as of September 30, 2010 and December 31, 2009 respectively.

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

|  | <b>Amortized<br/>cost</b> | <b>Gross<br/>unrealized<br/>gains</b> | <b>Gross<br/>unrealized<br/>losses</b> | <b>Fair value</b>     |
|--|---------------------------|---------------------------------------|--|-----------------------|
| <b>September 30, 2010</b>                        |                           |                                       |  |                       |
| U.S. treasury                                    | \$ 999,808                | \$ 40,426                             | \$                                     | \$ 1,040,234          |
| Government sponsored enterprises                 | 46,285,100                | 614,861                               | 1,303                                  | 46,898,658            |
| Asset-backed securities                          | 82,943,924                | 2,878,460                             |  | 85,822,384            |
| Obligations of states and political subdivisions | 30,340,035                | 1,073,842                             | 2,542                                  | 31,411,335            |
| <b>Total available for sale securities</b>       | <b>\$ 160,568,867</b>     | <b>\$ 4,607,589</b>                   | <b>\$ 3,845</b>                        | <b>\$ 165,172,611</b> |
| <b>December 31, 2009</b>                         |                           |                                       |  |                       |
| Government sponsored enterprises                 | \$ 44,059,540             | \$ 371,258                            | \$ 50,000                              | \$ 44,380,798         |
| Asset-backed securities                          | 68,092,852                | 1,585,774                             | 243,976                                | 69,434,650            |
| Obligations of states and political subdivisions | 38,456,246                | 708,196                               | 53,205                                 | 39,111,237            |
| <b>Total available for sale securities</b>       | <b>\$ 150,608,638</b>     | <b>\$ 2,665,228</b>                   | <b>\$ 347,181</b>                      | <b>\$ 152,926,685</b> |





The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2010 and December 31, 2009, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without prepayment penalties.

|   | Amortized<br>cost     | Fair<br>value         |
|---|-----------------------|-----------------------|
| Due in one year or less                               | \$ 3,716,849          | \$ 3,766,402          |
| Due after one year through five years                 | 57,445,491            | 58,400,399            |
| Due after five years through ten years                | 12,604,036            | 13,176,191            |
| Due after ten years                                   | 3,858,567             | 4,007,235             |
|   | 77,624,943            | 79,350,227            |
| Asset-backed securities                               | 82,943,924            | 85,822,384            |
| <b>Total available for sale investment securities</b> | <b>\$ 160,568,867</b> | <b>\$ 165,172,611</b> |

Debt securities with carrying values aggregating approximately \$141,473,000 and \$132,322,000 at September 30, 2010 and December 31, 2009, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

Gross unrealized losses on debt securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2010 and December 31, 2009, were as follows:

|  | Less than 12 months |                      | 12 months or<br>more |                      | Number<br>of<br>Investment<br>Positions | Total         |                      |
|--|---------------------|----------------------|----------------------|----------------------|---|---------------|----------------------|
|  | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value        | Unrealized<br>Losses |   | Fair<br>Value | Unrealized<br>Losses |
| <b>At September 30,<br/>2010</b>                 |                     |                      |                      |                      |   |               |                      |
| Government sponsored enterprises                 | \$ 998,697          | \$ (1,303)           | \$                   | \$                   | 1                                       | \$ 998,697    | \$ (1,303)           |
| Obligations of states and political subdivisions | 365,173             | (2,542)              |                      |                      | 2                                       | 365,173       | (2,542)              |
|  | \$ 1,363,870        | \$ (3,845)           | \$                   | \$                   | 3                                       | \$ 1,363,870  | \$ (3,845)           |

|                             | Less than 12 months |                      | 12 months or<br>more |                      | Number<br>of<br>Investment<br>Positions | Total         |                      |
|-----------------------------|---------------------|----------------------|----------------------|----------------------|---|---------------|----------------------|
|                             | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value        | Unrealized<br>Losses |   | Fair<br>Value | Unrealized<br>Losses |
| <b>At December 31, 2009</b> |                     |                      |                      |                      |   |               |                      |

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|  |               |              |           |         |    |               |              |
|--|---------------|--------------|-----------|---------|----|---------------|--------------|
| Government sponsored enterprises                 | \$ 5,943,819  | \$ (50,000)  | \$        | \$      | 6  | \$ 5,943,819  | (50,000)     |
| Asset-backed securities                          | 14,600,160    | (243,904)    | 20,551    | (72)    | 15 | 14,620,711    | \$ (243,976) |
| Obligations of states and political subdivisions | 3,576,780     | (53,205)     |           |         | 14 | 3,576,780     | (53,205)     |
|  | \$ 24,120,759 | \$ (347,109) | \$ 20,551 | \$ (72) | 35 | \$ 24,141,310 | \$ (347,181) |

Our Company's available for sale portfolio consisted of approximately 304 securities at September 30, 2010, of which 3 securities were temporarily impaired. None of these securities have been in the loss position for 12 months or longer. Our Company believes the \$4,000 in unrealized losses included in other comprehensive income at September 30, 2010 is attributable to changes in market interest rates and not the credit quality of the issuer and are not considered other-than-temporarily impaired. Our Company does not intend to sell these investments and it is not more likely than not that our Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity.

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

considered other-than-temporarily impaired. As of September 30, 2010, this security was not in the unrealized loss position.

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

#### **Intangible Assets**

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

|  | September 30, 2010    |                          |                     | December 31, 2009     |                          |                     |
|--|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
|  | Gross Carrying Amount | Accumulated Amortization | Net Amount          | Gross Carrying Amount | Accumulated Amortization | Net Amount          |
| Amortizable intangible assets:             |                       |                          |                     |                       |                          |                     |
| Core deposit intangible                    | \$ 7,060,224          | \$ (5,964,689)           | \$ 1,095,535        | \$ 7,060,224          | \$ (5,556,238)           | \$ 1,503,986        |
| Mortgage servicing rights                  | 2,880,735             | (681,848)                | 2,198,887           | 2,945,019             | (924,055)                | 2,020,964           |
| <b>Total amortizable intangible assets</b> | <b>\$ 9,940,959</b>   | <b>\$ (6,646,537)</b>    | <b>\$ 3,294,422</b> | <b>\$ 10,005,243</b>  | <b>\$ (6,480,293)</b>    | <b>\$ 3,524,950</b> |

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

|                                      | Core Deposit Intangible Asset | Mortgage Servicing Rights |
|--------------------------------------|-------------------------------|---------------------------|
| Balance at December 31, 2009         | \$ 1,503,986                  | \$ 2,020,964              |
| Additions                            |                               | 772,880                   |
| Amortization                         | (408,451)                     | (594,957)                 |
| <b>Balance at September 30, 2010</b> | <b>\$ 1,095,535</b>           | <b>\$ 2,198,887</b>       |

Mortgage servicing rights (MSRs) are amortized over the shorter of 7 years or the life of the loan. They are periodically reviewed for impairment and if impairment is indicated, recorded at fair value. At September 30, 2010 and December 31, 2009, no temporary impairment was recognized. The fair value of MSRs is based on the present value of expected cash flows, as further discussed in *Fair Value of Financial Instruments*. Mortgage loans serviced for others totaled approximately \$285,888,000 and \$269,475,000 at September 30, 2010 and December 31, 2009, respectively. Included in other noninterest income were real estate servicing fees for the nine months ended September 30, 2010 and 2009 of \$682,000 and \$648,000, respectively.

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

|      | <b>Core<br/>Deposit<br/>Intangible<br/>Asset</b> | <b>Mortgage<br/>Servicing<br/>Rights</b> |
|------|--|--|
| 2010 | \$ 118,026                                       | \$ 440,000                               |
| 2011 | 434,763  | 477,000                                  |
| 2012 | 408,062  | 363,000                                  |
| 2013 | 134,684  | 277,000                                  |
| 2014 |  | 212,000                                  |
| 2015 |  | 162,000                                  |

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

| Aggregate amortization expense | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|--------------------------------|-------------------------------------|------------|------------------------------------|------------|
|                                | 2010                                | 2009       | 2010                               | 2009       |
| Core deposit intangible asset  | \$ 118,026                          | \$ 150,519 | \$ 408,451                         | \$ 475,592 |
| Mortgage servicing rights      | 307,981                             | 156,365    | 594,957                            | 746,682    |

### *Income Taxes*

At September 30, 2010 and December 31, 2009, our Company had \$562,000 of gross unrecognized tax benefits that if recognized would affect the effective tax rate. Our Company believes that during the next twelve months it is reasonably possible that there would be a reduction of \$222,000 in gross unrecognized tax benefits as a result of the lapse of statute of limitations for the 2006 tax year. At September 30, 2010, total interest accrued on unrecognized tax benefits was approximately \$59,000. As of September 30, 2010, there were no federal or state income tax examinations in process.

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

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 27.2% for the three months ended September 30, 2010 compared to 30.6% for the three months ended September 30, 2009. Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 27.6% for the nine months ended September 30, 2010 compared to 31.2% for the nine months ended September 30, 2009. The effective tax rate for the three and nine months ended September 30, 2010 reflects the increase in tax-exempt income as a percentage of total taxable income.

### *Employee Benefit Plans*

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

|                         | For the Three Months<br>Ended<br>September 30, |              | For the Nine Months<br>Ended<br>September 30, |              |
|-------------------------|--|--------------|---|--------------|
|                         | 2010   | 2009         | 2010  | 2009         |
| Payroll taxes           | \$ 257,947                                     | \$ 246,232   | \$ 863,587                                    | \$ 855,230   |
| Medical plans           | 372,789  | 370,113      | 1,171,144                                     | 1,127,477    |
| 401k match              | 84,300   | 81,045       | 238,088                                       | 227,902      |
| Pension plan            | 216,298  | 229,000      | 648,895                                       | 687,000      |
| Profit-sharing          | (72,468)                                       | 99,000       | 2   | 233,350      |
| Other                   | 28,288   | 28,906       | 102,304                                       | 81,538       |
| Total employee benefits | \$ 887,154                                     | \$ 1,054,296 | \$ 3,024,020                                  | \$ 3,212,497 |



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

|   | <b>Estimated<br/>2010</b> | <b>Actual<br/>2009</b> |
|---|---------------------------|------------------------|
| Service cost – benefits earned during the year                  | \$ 844,178                | \$ 850,940             |
| Interest cost on projected benefit obligations                  | 556,047                   | 509,482                |
| Expected return on plan assets                                  | (613,659)                 | (539,283)              |
| Amortization of prior service cost                              | 78,628                    | 78,628                 |
| Amortization of net gains                                       |                           | (9,075)                |
| <br>Net periodic pension expense – Annual                       | <br>\$ 865,194            | <br>\$ 890,692         |
| <br>Pension expense – three months ended September 30, (actual) | <br>\$ 216,298            | <br>\$ 229,000         |
| Pension expense – nine months ended September 30, (actual)      | \$ 648,895                | \$ 687,000             |

Our Company made a \$1,000,000 contribution to the defined benefit plan in 2009, and the minimum required contribution for 2010 is estimated to be \$864,000. Our Company has contributed \$554,000 through October 2010.

#### ***Stock-Based Compensation***

Our Company's stock option plan provides for the grant of options to purchase up to 486,720 shares of our Company's common stock to officers and other key employees of our Company and its subsidiaries. All options have been granted at exercise prices equal to fair value and vest over periods ranging from four to five years, except 10,294 options issued in 2008 that vested immediately.

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

|                                       | <b>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(000)</b> | <b>Weighted<br/>Average<br/>Contractual<br/>Term<br/>(in years)</b> |
|---------------------------------------|----------------|--|--|---|
| Outstanding at January 1, 2010*       | 286,948        | \$ 24.11   |  |   |
| Granted                               |                |  |  |   |
| Exercised                             |                |  |  |   |
| Forfeited                             |                |  |  |   |
| Canceled                              |                |  |  |   |
| <br>Outstanding at September 30, 2010 | <br>286,948    | <br>\$ 24.11                                       | <br>\$   | <br>4.2   |
| Exercisable at September 30, 2010     | 245,617        | \$ 23.96   | \$   | 3.7   |

\* Options have been adjusted to reflect a 4% stock dividend paid on July 1, 2010.

Total stock-based compensation expense for the three and nine months ended September 30, 2010 and 2009 was \$19,000 and \$31,000, respectively, and \$68,000 and \$100,000, respectively. As of September 30, 2010, the total unrecognized compensation expense related to non-vested stock awards was \$100,000 and the related weighted

average period over which it is expected to be recognized is approximately three years.



**Comprehensive Income**

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

|  | <b>Three Months Ended<br/>September 30,</b> |              | <b>Nine Months Ended<br/>September 30,</b> |              |
|--|---|--------------|--|--------------|
|  | <b>2010</b>                                 | <b>2009</b>  | <b>2010</b>                                | <b>2009</b>  |
| Net income   | \$ 1,422,202                                | \$ 1,906,778 | \$ 2,698,436                               | \$ 4,167,697 |
| Other comprehensive income:  |   |              |  |              |
| Unrealized gain on securities:   |   |              |  |              |
| Unrealized gain on debt and equity securities available-for-sale, net of tax         | 249,006                                     | 808,079      | 1,394,275                                  | 558,218      |
| Defined benefit pension plan:  |   |              |  |              |
| Amortization of prior service cost included in net periodic pension cost, net of tax | 11,991                                      | 12,052       | 35,973                                     | 36,142       |
| Total other comprehensive income   | 260,997                                     | 820,131      | 1,430,248                                  | 594,360      |
| Comprehensive income   | \$ 1,683,199                                | \$ 2,726,909 | \$ 4,128,684                               | \$ 4,762,057 |

**Preferred Stock**

On December 19, 2008, our Company announced its participation in the U.S. Treasury Department's Capital Purchase Program (CPP), a voluntary program that provides capital to financially healthy banks. This program was designed to attract broad participation by banking institutions to help stabilize the financial system by encouraging lending. Our Company has used the funds received, as discussed below, to continue to provide loans to its customers and to look for ways to deploy additional funds to benefit the communities in our Company's market area.

Participation in this program included our Company's issuance of 30,255 shares of senior preferred stock (with a par value of \$1,000 per share) and a ten year warrant to purchase approximately 265,471 shares of common stock (see below for additional information) to the U.S. Department of Treasury in exchange for \$30,255,000. The proceeds received were allocated between the preferred stock and the common stock warrant based upon their relative fair values. This resulted in the recording of a discount on the preferred stock upon issuance that reflects the value allocated to the warrant. The discount on the preferred stock will be accreted over five years, consistent with management's estimate of the life of the preferred stock. Such accretion will be treated as additional dividends on the preferred stock. The allocated carrying values of the senior preferred stock and common stock warrants at September 30, 2010 were \$28,722,000 and \$2,382,000, respectively.

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

The common stock warrant is exercisable immediately with a ten year term, in whole or in part, at an exercise price of \$17.10 per share. The preferred stock and warrant are classified as stockholders' equity in the consolidated balance sheets and qualify, for regulatory capital purposes, as Tier I capital. For the nine months ended September 30, 2010, our Company had declared and paid dividends in the amount of \$1,135,000 on the preferred stock.



**Earnings per Share**

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the three and nine months ending September 30, 2010. Diluted earnings per share gives effect to all dilutive potential common shares that were outstanding during the three and nine months ending September 30, 2010.

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

|   | <b>For the Three Months<br/>Ended<br/>September 30,<br/>2010</b> |              | <b>For the Nine Months<br/>Ended<br/>September 30,<br/>2010</b> |              |
|---|--|--------------|---|--------------|
|   | <b>2010</b>  | <b>2009</b>  | <b>2010</b>   | <b>2009</b>  |
| <b>Basic income per common share:</b>                       |  |              |   |              |
| <b>Net income</b>   | \$ 1,422,202   | \$ 1,906,778 | \$ 2,698,436  | \$ 4,167,697 |
| Less:   |  |              |   |              |
| Preferred stock dividends                                   | 378,187  | 378,187      | 1,130,360   | 1,134,562    |
| Accretion of discount on preferred stock                    | 119,119  | 119,119      | 357,356   | 357,356      |
| Net income available to common shareholders                 | \$ 924,896   | \$ 1,409,472 | \$ 1,210,720  | \$ 2,675,779 |
| <b>Basic earnings per share</b>                             | \$ 0.21  | \$ 0.32      | \$ 0.27   | \$ 0.60      |
| <b>Diluted earnings per common share:</b>                   |  |              |   |              |
| <b>Net income</b>   | \$ 1,422,202   | \$ 1,906,778 | \$ 2,698,436  | \$ 4,167,697 |
| Less:   |  |              |   |              |
| Preferred stock dividends                                   | 378,187  | 378,187      | 1,130,360   | 1,134,562    |
| Accretion of discount on preferred stock                    | 119,119  | 119,119      | 357,356   | 357,356      |
| Net income available to common shareholders                 | \$ 924,896   | \$ 1,409,472 | \$ 1,210,720  | \$ 2,675,779 |
| Average shares outstanding                                  | 4,474,033  | 4,474,033    | 4,474,033   | 4,474,033    |
| Effect of dilutive stock options                            |  |              |   |              |
| Average shares outstanding including dilutive stock options | 4,474,033  | 4,474,033    | 4,474,033   | 4,474,033    |
| <b>Diluted earnings per share</b>                           | \$ 0.21  | \$ 0.32      | \$ 0.27   | \$ 0.60      |

Under the treasury stock method, outstanding stock options are dilutive when the average market price of our Company's common stock, when combined with the effect of any unamortized compensation expense, exceeds the option price during the period, except when our Company has a loss from continuing operations available to common shareholders. In addition, proceeds from the assumed exercise of dilutive options along with the related tax benefit are assumed to be used to repurchase common shares at the average market price of such stock during the period.

The following options and warrant to purchase shares during the three and nine months ended 2010 and 2009 were not included in the respective computations of diluted earnings per share because the exercise price, when

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combined with the effect of the unamortized compensation expense, was greater than the average market price of the common shares and were considered anti-dilutive.

|                      |                | Three months ended<br>September 30, |         | Nine months ended<br>September 30, |         |
|----------------------|----------------|-------------------------------------|---------|------------------------------------|---------|
|                      |                | 2010                                | 2009    | 2010                               | 2009    |
| Anti-dilutive shares | option shares  | 286,948                             | 286,948 | 286,948                            | 286,948 |
| Anti-dilutive shares | warrant shares | 265,471                             | 265,471 | 265,471                            | 265,471 |

## **Fair Value Measurements**

Our Company uses fair value measurements to record fair value adjustments to certain financial and nonfinancial assets and liabilities. The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements and Disclosures*, defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The standard applies whenever other standards require (permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, FASB clarified the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. As of September 30, 2010 and December 31, 2009 there were no transfers into or out of Level 2.

The fair value hierarchy is as follows:

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

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

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

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

Our Company is required to disclose assets and liabilities measured at fair value on a recurring basis separate from those measured at fair value on a nonrecurring basis. Nonfinancial assets measured at fair value on a nonrecurring basis would include foreclosed real estate, long-lived assets, and core deposit intangible assets, which are reviewed when circumstances or other events indicate that impairment may have occurred.

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

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

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

#### *Available-for-sale securities*

Available-for-sale securities are recorded at fair value on a recurring basis. Available-for-sale securities is the only balance sheet category our Company is required, in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), to carry at fair value on a recurring basis. Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, our Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

| Description                                      | Fair Value Measurements<br>At September 30, 2010 Using |   |  |  |
|--|--|---|--|--|
|  | Fair Value<br>September 30,<br>2010                    | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| U.S. treasury                                    | \$ 1,040,234   | \$  | \$ 1,040,234                               | \$   |
| Government sponsored enterprises                 | 46,898,658   |   | 46,898,658                                 |  |
| Asset-backed securities                          | 85,822,384   |   | 85,822,384                                 |  |
| Obligations of states and political subdivisions | 31,411,335   |   | 31,411,335                                 |  |
| Total  | \$ 165,172,611   | \$  | \$ 165,172,611                             | \$   |

| Description                                      | Fair Value Measurements<br>At December 31, 2009 Using |   |  |  |
|--|---|---|--|--|
|  | Fair Value<br>December 31,<br>2009                    | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Government sponsored enterprises                 | \$ 44,380,798   | \$  | \$ 44,380,798                              | \$   |
| Asset-backed securities                          | 69,434,650  |   | 69,434,650                                 |  |
| Obligations of states and political subdivisions | 39,111,237  |   | 39,111,237                                 |  |
| Total  | \$ 152,926,685  | \$  | \$ 152,926,685                             | \$   |

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

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

##### *Impaired Loans*

Our Company does not record loans at fair value on a recurring basis other than loans that are considered impaired. The fair value of impaired loans are generally based on market prices for loans with similar collateral determined through independent appraisals, the fair value of the collateral for a collateral-dependent loan, 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 September 30, 2010, our Company identified \$34.7 million in impaired loans that had specific allowances for losses aggregating \$7.8 million. Related to these loans, there was \$7.2 million in charge-offs recorded during 2010. As of December 31, 2009, our Company identified \$26.3 million in impaired loans that had specific allowances for losses aggregating \$6.4 million. Related to these loans, there was \$4.2 million in charge-offs recorded during 2009.

*Other Real Estate Owned and Repossessed Assets*

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

**Fair Value Measurements  
At September 30, 2010 Using**

| Description                                       | Fair Value<br>September<br>30,<br>2010 | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical |    |  | Other<br>Observable<br>Inputs<br>(Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Nine Months<br>Ended<br>September<br>30,<br>2010<br><br>Total Gains<br>(Losses) * |
|---|--|---|----|--|---|--|---|
|   |  | Assets<br>(Level<br>1)  |    |  |   |  |   |
| Impaired loans:                                   |  |   |    |  |   |  |   |
| Commercial  | \$ 1,094,006                           | \$  | \$ |  | \$ 1,094,006                                  | \$ (1,355,716)                                     |   |
| Construction residential                          | 1,859,653                              |   |    |  | 1,859,653                                     | (324,742)  |   |
| Construction commercial                           | 14,372,565                             |   |    |  | 14,372,565                                    | (64,000)   |   |
| Real estate residential                           | 5,129,696                              |   |    |  | 5,129,696                                     | (3,238,263)  |   |
| Real estate commercial                            | 4,462,467                              |   |    |  | 4,462,467                                     | (2,188,893)  |   |
| Total   | \$ 26,918,387                          | \$  | \$ |  | 26,918,387                                    | \$ (7,171,614)                                     |   |
| Other real estate owned and<br>repossessed assets | \$ 10,012,412                          | \$  | \$ |  | \$ 10,012,412                                 | \$ (3,002,454)                                     |   |

\* Total gains (losses) include charge offs, valuation write downs, and net losses taken on impaired loans and other real estate owned during the periods reported.

**Fair Value Measurements  
At December 31, 2009 Using**

| Description              | Fair Value<br>December<br>31,<br>2009 | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical |    |  | Other<br>Observable<br>Inputs<br>(Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Year<br>Ended<br>December<br>31,<br>2009<br><br>Total Gains<br>(Losses) * |
|--------------------------|---------------------------------------|---|----|--|---|--|---|
|                          |                                       | Assets<br>(Level<br>1)  |    |  |   |  |   |
| Impaired loans:          |                                       |   |    |  |   |  |   |
| Commercial               | \$ 970,937                            | \$  | \$ |  | \$ 970,937                                    | \$ (1,043,465)                                     |   |
| Construction residential | 1,776,267                             |   |    |  | 1,776,267                                     | (778,041)  |   |
| Construction commercial  | 272,106                               |   |    |  | 272,106                                       | (160,727)  |   |



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|  |               |    |               |                |
|--|---------------|----|---------------|----------------|
| Real estate residential                        | 7,104,961     |    | 7,104,961     | (1,914,530)    |
| Real estate commercial                         | 9,755,560     |    | 9,755,560     | (323,522)      |
| Total  | \$ 19,879,831 | \$ | \$ 19,879,831 | \$ (4,220,285) |
| Other real estate owned and repossessed assets | \$ 8,490,914  | \$ | \$ 8,490,914  | \$ (1,367,207) |

\* Total gains (losses) include charge offs, valuation write downs, and net losses taken on impaired loans and other real estate owned during the periods reported.

For both recurring and nonrecurring fair value measurements, there were no transfers between the various levels for the nine months ending September 30, 2010 or the year ended December 31, 2009.

***Fair Value of Financial Instruments***

The carrying amounts and estimated fair values of financial instruments held by our Company, in addition to a discussion of the methods used and assumptions made in computing those estimates, are set forth below.

***Loans***

The fair value of loans is estimated based on present values using applicable risk-adjusted spreads to the U. S. Treasury curve to approximate current interest rates applicable to each category of such financial instruments. The fair values of impaired loans are generally based on market prices for similar assets determined through independent appraisals or discounted values of independent appraisals and brokers' opinions of value. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC Topic 820.

***Investment Securities***

A detailed description of the fair value measurement of the debt instruments in the available for sale sections of the investment security portfolio is 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*.

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

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

***Mortgage Servicing Rights***

The fair value of mortgage servicing rights is calculated by pooling loans into buckets of loans having similar characteristics and performing a present value analysis of future cash flows utilizing the current market rate. The buckets are created based on individual loans characteristics such as loan age, note rate, product type, and the investor remittance schedule.

***Accrued Interest Receivable and Payable***

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

***Deposits***

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

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

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

***Other Borrowings***

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

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

|  | September 30,<br>2010 |                  | December 31,<br>2009 |                  |
|--|-----------------------|------------------|----------------------|------------------|
|  | Carrying<br>amount    | Fair<br>value    | Carrying<br>amount   | Fair<br>value    |
| <b>Assets:</b>   |                       |                  |                      |                  |
| Loans  | \$ 919,502,615        | \$ 925,518,000   | \$ 976,817,458       | \$ 984,305,000   |
| Investment in debt securities  | 165,172,611           | 165,172,611      | 152,926,685          | 152,926,685      |
| Federal fund sold and securities<br>purchased under agreements to resell         | 125,820               | 125,820          | 89,752               | 89,752           |
| Cash and due from banks  | 52,099,695            | 52,099,695       | 24,575,943           | 24,575,943       |
| Mortgage servicing rights  | 2,198,887             | 3,082,000        | 2,020,964            | 2,904,000        |
| Accrued interest receivable  | 6,020,411             | 6,020,411        | 6,625,557            | 6,625,557        |
|  | \$ 1,145,120,039      | \$ 1,152,018,537 | \$ 1,163,056,359     | \$ 1,171,426,937 |
| <b>Liabilities:</b>  |                       |                  |                      |                  |
| Deposits:  |                       |                  |                      |                  |
| Demand   | \$ 143,143,196        | \$ 143,143,196   | \$ 135,017,639       | \$ 135,017,639   |
| NOW  | 148,709,953           | 148,709,953      | 139,623,577          | 139,623,577      |
| Savings  | 53,502,642            | 53,502,642       | 47,637,148           | 47,637,148       |
| Money market   | 161,704,012           | 161,704,012      | 167,023,279          | 167,023,279      |
| Time   | 443,514,151           | 453,030,000      | 467,021,154          | 478,011,000      |
| Federal funds purchased and<br>securities sold under agreements to<br>repurchase | 31,460,010            | 31,460,010       | 36,645,434           | 36,645,434       |
| Subordinated notes   | 49,486,000            | 21,106,000       | 49,486,000           | 18,329,000       |
| Other borrowings   | 67,168,047            | 69,695,000       | 79,317,302           | 80,557,000       |
| Accrued interest payable   | 1,344,701             | 1,344,701        | 2,438,121            | 2,438,121        |
|  | \$ 1,100,032,712      | \$ 1,083,695,514 | \$ 1,124,209,654     | \$ 1,105,282,198 |

**Item 2 - Management's Discussion and Analysis of Financial Condition  
And Results of Operations**

**Forward-Looking Statements**

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

statements that are not historical in nature, and

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

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

competitive pressures among financial services companies may increase significantly,

changes in the interest rate environment may reduce interest margins,

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

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

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

legislative or regulatory changes may adversely affect the business in which our Company and its subsidiaries are engaged, including those discussed below in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and

changes may occur in the securities markets.

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

We have described under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2009 and in other reports that we file with the SEC from time to time, additional factors that could cause actual results to be materially different from those described in the forward-looking statements. Other factors that we have not identified in this report could also have this effect. You are cautioned not to put undue reliance on any forward-looking statement, which speak only as of the date they were made.

**Overview**

Our Company, Hawthorn Bancshares, Inc., is a community-based, financial institution bank holding company headquartered in Lee's Summit, Missouri. Our Company was incorporated under the laws of the State of Missouri on October 23, 1992 as Exchange National Bancshares, Inc. and changed its name to Hawthorn Bancshares, Inc. in August 2007. Our Company owns all of the issued and outstanding capital stock of Union State Bancshares, Inc., which in turn owns all of the issued and outstanding capital stock of Hawthorn Bank. Our Company conducts

operations primarily through our Bank. Our Bank, a state chartered bank, had \$1.22 billion in assets at September 30, 2010, and 24 full-service banking offices, including its principal office in Jefferson City, Missouri. Our Bank is committed to providing the most

up-to-date financial products and services and delivering these products and services to our market area with superior customer service.

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

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

#### ***Critical Accounting Policies***

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

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

We have identified the accounting policy related to the allowance for loan losses as critical to the understanding of our Company's results of operations, since the application of this policy requires significant management assumptions and estimates that could result in materially different amounts to be reported if conditions or underlying circumstances were to change. Collateral values and historical loss experience are significant inputs and estimates used to measure losses within the reserve methodology. The impact and any associated risks related to these policies on our business operations are discussed in the Lending and Credit Management section below.

#### ***Income Taxes***

Income taxes are accounted for under the asset / liability method by recognizing the amount of taxes payable or refundable for the current period and deferred tax assets and liabilities for future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in addressing our Company's future tax consequences of events that have been recognized in the consolidated financial statements or tax returns such as realization of the effects of temporary differences, net operating loss carry forward, and changes in tax laws or interpretations thereof. A valuation allowance is established when in the judgment of management, it is more likely than not that such deferred tax assets will not become realizable. In this case, our Company would adjust the recorded value of our deferred tax asset, which would result in a direct charge to income tax expense in the period that the determination was made. Likewise, our Company would reverse the valuation allowance when the realization of the deferred tax asset is expected. In addition, our Company is subject to the continuous examination of our tax returns by the Internal Revenue Service and other taxing authorities. Our Company accrues for interest related to income taxes in income tax expense. A total interest benefit recognized for the nine months ended September 30, 2010 and 2009 was \$35,000 and \$23,000, respectively. As of September 30, 2010 and December 31, 2009, total accrued interest was \$113,000 and \$94,000, respectively

**SELECTED CONSOLIDATED FINANCIAL DATA**

The following table presents selected consolidated financial information for our Company as of and for each of the three and nine month periods ended September 30, 2010 and September 30, 2009. The selected consolidated financial data should be read in conjunction with the Consolidated Financial Statements of our Company, including the accompanying notes, presented elsewhere herein.

**Selected Financial Data**

| (In thousands, except per share data)                       | Three Months<br>Ended<br>September 30, |         | Nine Months<br>Ended<br>September 30, |         |
|---|--|---------|---------------------------------------|---------|
|   | 2010                                   | 2009    | 2010                                  | 2009    |
| <b>Per Share Data</b>                                       |  |         |                                       |         |
| Basic earnings per common share                             | \$ 0.21                                | \$ 0.32 | \$ 0.27                               | \$ 0.60 |
| Diluted earnings per common share                           | 0.21                                   | 0.32    | 0.27                                  | 0.60    |
| Dividends paid on preferred stock                           | 378                                    | 378     | 1,130                                 | 1,135   |
| Amortization of discount on preferred stock                 | 119                                    | 119     | 357                                   | 357     |
| Dividends paid on common stock                              | 215                                    | 455     | 1,161                                 | 2,192   |
| Book value per common share                                 |  |         | 18.15                                 | 17.94   |
| Market price common stock                                   |  |         | 10.08                                 | 9.75    |
| <b>Selected Ratios</b>                                      |  |         |                                       |         |
| <i>(Based on average balance sheets)</i>                    |  |         |                                       |         |
| Return on average total assets                              | 0.46%                                  | 0.60%   | 0.29%                                 | 0.44%   |
| Return on average common stockholders' equity               | 4.52%                                  | 7.03%   | 2.01%                                 | 4.51%   |
| Average common stockholders' equity to average total assets | 6.62%                                  | 6.33%   | 6.46%                                 | 6.28%   |
| <i>(Based on end-of-period data)</i>                        |  |         |                                       |         |
| Efficiency ratio (1)  | 68.02%                                 | 69.35%  | 72.68%                                | 72.59%  |
| Period-end stockholders' equity to period-end assets        |  |         | 6.68%                                 | 6.47%   |
| Period-end common stockholders' equity to period-end assets |  |         | 9.05%                                 | 8.75%   |
| Total risk-based capital ratio                              |  |         | 17.47                                 | 16.50   |
| Tier 1 risk-based capital ratio                             |  |         | 14.94                                 | 14.01   |
| Leverage ratio  |  |         | 11.61                                 | 11.24   |

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

**Results of Operations  
Summary**

| <i>(Dollars in thousands)</i>                      | Three Months<br>Ended September 30, |           |              |             | Nine Months<br>Ended September 30, |           |              |             |
|--|-------------------------------------|-----------|--------------|-------------|------------------------------------|-----------|--------------|-------------|
|  | 2010                                | 2009      | \$<br>Change | %<br>Change | 2010                               | 2009      | \$<br>Change | %<br>Change |
| Net interest income                                | \$ 10,859                           | \$ 10,436 | \$ 423       | 4.1%        | \$ 32,284                          | \$ 29,984 | \$ 2,300     | 7.7%        |
| Provision for loan losses                          | 2,450                               | 1,250     | 1,200        | 96.0        | 7,105                              | 4,404     | 2,701        | 61.3        |
| Noninterest income                                 | 2,910                               | 2,600     | 310          | 11.9        | 7,366                              | 8,173     | (807)        | (9.9)       |
| Noninterest expense                                | 9,366                               | 9,040     | 326          | 3.6         | 28,816                             | 27,696    | 1,120        | 4.0         |
| <b>Income before income taxes</b>                  | 1,953                               | 2,746     | (793)        | (28.9)      | 3,729                              | 6,057     | (2,328)      | (38.4)      |
| Income taxes                                       | 531                                 | 840       | (309)        | (36.8)      | 1,031                              | 1,889     | (858)        | (45.4)      |
| <b>Net income</b>                                  | \$ 1,422                            | \$ 1,906  | \$ (484)     | (25.4)%     | \$ 2,698                           | \$ 4,168  | \$ (1,470)   | (35.3)%     |
| Less: preferred dividends                          | 378                                 | 378       |              |             | 1,130                              | 1,135     |              |             |
| Less: accretion of discount on preferred stock     | 119                                 | 119       |              |             | 357                                | 357       |              |             |
| <b>Net income available to common shareholders</b> | \$ 925                              | \$ 1,409  | \$ (484)     | (34.4)%     | \$ 1,211                           | \$ 2,676  | \$ (1,465)   | (54.7)%     |

Our Company's consolidated net income of \$1,422,000 for the three months ended September 30, 2010 decreased \$484,000, or 25.4%, compared to the three months ended September 30, 2009. Our Company recorded preferred stock dividends and accretion on preferred stock of \$497,000 in the three months ended September 30, 2010, resulting in \$925,000 of net income available to common shareholders, compared to \$1,409,000 for the three months ended September 30, 2009. Diluted earnings per share decreased from \$0.32 per common share to \$0.21 per common share. Results for the three months ended September 30, 2010 were negatively impacted by the \$2,450,000 provision for loan losses compared to \$1,250,000 for the same period in 2009. Our Company experienced an increase in real estate refinancing activity during the third quarter of 2010 that partially offset the increase in the provision through increasing gains on sale of mortgage loans. For the three months ended September 30, 2010, the annualized return on average assets was 0.46%, the annualized return on average common shareholders' equity was 4.52%, and the efficiency ratio was 68.0%. Net interest margin increased from 3.57% to 3.81%. Net interest income, on a tax equivalent basis, increased \$394,000 or 3.71% from 2009 to 2010.

Our Company's consolidated net income of \$2,698,000 for the nine months ended September 30, 2010 decreased \$1,470,000, or 35.3%, compared to the nine months ended September 30, 2009. Our Company recorded preferred stock dividends and accretion on preferred stock of \$1,487,000 in the first nine months of 2010, resulting in \$1,211,000 of net income available to common shareholders, compared to \$2,676,000 for the first nine months of 2009. Diluted earnings per share decreased from \$0.60 per common share to \$0.27 per common share. Results for the nine months ended September 30, 2010 were negatively impacted by the \$7,105,000 provision for loan losses compared to \$4,404,000 for the same period in 2009. Although real estate refinancing activity substantially increased



during the third quarter of 2010, the overall decrease in noninterest income was primarily due to lower gain on sales of mortgage loans during the first nine months of 2010 in comparison to the same time period during 2009. For the nine months September 30, 2010, the annualized return on average assets was 0.29%, the annualized return on average common shareholders' equity was 2.01%, and the efficiency ratio was 72.7%. Net interest margin increased from 3.44% to 3.77%. Net interest income, on a tax equivalent basis, increased \$2,242,000 or 7.3% from 2009 to 2010.

Total assets at September 30, 2010 were \$1,215,066,000, compared to \$1,236,470,000 at December 31, 2009, a decrease of \$21,404,000, or 1.7%.

**Net Interest Income**

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

**Average Balance Sheets**

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

| (dollars in thousands)                                    | <b>Three Months Ended September 30,</b> |   |                                     |                            |   |                                     |
|---|---|---|-------------------------------------|----------------------------|---|-------------------------------------|
|   | <b>Average<br/>Balance</b>              | <b>2010<br/>Interest<br/>Income/<br/>Expense(1)</b> | <b>Rate<br/>Earned/<br/>Paid(1)</b> | <b>Average<br/>Balance</b> | <b>2009<br/>Interest<br/>Income/<br/>Expense(1)</b> | <b>Rate<br/>Earned/<br/>Paid(1)</b> |
| <b>ASSETS</b>   |   |   |                                     |                            |   |                                     |
| Loans (2)(4)  |   |   |                                     |                            |   |                                     |
| Commercial  | \$ 136,613                              | \$ 1,929  | 5.60%                               | \$ 149,059                 | \$ 2,040  | 5.43%                               |
| Real estate construction residential                      | 38,374                                  | 516   | 5.33                                | 43,026                     | 488   | 4.50                                |
| Real estate construction commercial                       | 76,356                                  | 764   | 3.97                                | 76,115                     | 838   | 4.37                                |
| Real estate mortgage residential                          | 213,774                                 | 3,174   | 5.89                                | 277,626                    | 3,556   | 5.08                                |
| Real estate mortgage commercial                           | 439,261                                 | 6,266   | 5.66                                | 421,172                    | 6,786   | 6.39                                |
| Consumer  | 34,583                                  | 615   | 7.06                                | 35,254                     | 659   | 7.42                                |
| Investment in securities: (3)                             |   |   |                                     |                            |   |                                     |
| U.S. Treasury   | 1,028                                   | 5   | 1.93                                |                            |   |                                     |
| Government sponsored enterprises                          | 49,311                                  | 301   | 2.42                                | 48,915                     | 469   | 3.80                                |
| Asset backed securities                                   | 83,450                                  | 742   | 3.53                                | 65,858                     | 662   | 3.99                                |
| State and municipal                                       | 31,489                                  | 411   | 5.18                                | 39,527                     | 536   | 5.38                                |
| Restricted investments                                    | 6,310                                   | 34  | 2.14                                | 8,875                      | 54  | 2.41                                |
| Federal funds sold  | 183                                     |   |                                     | 262                        |   |                                     |
| Interest bearing deposits in other financial institutions | 36,223                                  | 28  | 0.31                                | 14,288                     | 11  | 0.31                                |
| <b>Total interest earning assets</b>                      | 1,146,955                               | 14,785  | 5.11                                | 1,179,977                  | 16,099  | 5.41                                |
| All other assets  | 92,794                                  |   |                                     | 89,610                     |   |                                     |
| Allowance for loan losses                                 | (12,654)                                |   |                                     | (13,857)                   |   |                                     |
| <b>Total assets</b>                                       | \$ 1,227,095                            |   |                                     | \$ 1,255,730               |   |                                     |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                |   |   |                                     |                            |   |                                     |
| NOW accounts  | \$ 163,142                              | \$ 226  | 0.55%                               | \$ 138,149                 | \$ 268  | 0.77%                               |
| Savings   | 53,128                                  | 33  | 0.25                                | 47,199                     | 35  | 0.29                                |
| Money market  | 165,480                                 | 253   | 0.61                                | 178,719                    | 389   | 0.86                                |
| Time deposits of \$100,000 and over                       | 127,889                                 | 595   | 1.85                                | 141,791                    | 950   | 2.66                                |

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|  |                     |                  |              |                     |                  |              |
|--|---------------------|------------------|--------------|---------------------|------------------|--------------|
| Other time deposits  | 318,075             | 1,758            | 2.19         | 347,783             | 2,532            | 2.89         |
| <b>Total time deposits</b>   | <b>827,714</b>      | <b>2,865</b>     | <b>1.37</b>  | <b>853,641</b>      | <b>4,174</b>     | <b>1.94</b>  |
| Federal funds purchased and securities sold under agreements to repurchase | 32,149              | 20               | 0.25         | 36,416              | 23               | 0.25         |
| Subordinated notes   | 49,486              | 353              | 2.83         | 49,486              | 589              | 4.72         |
| Other borrowed money   | 68,644              | 528              | 3.05         | 71,603              | 688              | 3.81         |
| <b>Total interest bearing liabilities</b>                                  | <b>977,993</b>      | <b>3,766</b>     | <b>1.53</b>  | <b>1,011,146</b>    | <b>5,474</b>     | <b>2.15</b>  |
| Demand deposits  | 133,196             |                  |              | 125,092             |                  |              |
| Other liabilities  | 6,028               |                  |              | 11,794              |                  |              |
| <b>Total liabilities</b>   | <b>1,117,217</b>    |                  |              | <b>1,148,032</b>    |                  |              |
| Stockholders equity  | 109,878             |                  |              | 107,698             |                  |              |
| <b>Total liabilities and stockholders equity</b>                           | <b>\$ 1,227,095</b> |                  |              | <b>\$ 1,255,730</b> |                  |              |
| <b>Net interest income (FTE)</b>   |                     | <b>\$ 11,019</b> |              |                     | <b>\$ 10,625</b> |              |
| <b>Net interest spread</b>   |                     |                  | <b>3.58%</b> |                     |                  | <b>3.26%</b> |
| <b>Net interest margin</b>   |                     |                  | <b>3.81%</b> |                     |                  | <b>3.57%</b> |

- (1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 35%, net of nondeductible interest expense. Such adjustments totaled \$161,000 and \$189,000 for the three months ended September 30, 2010 and 2009, respectively.
- (2) Non-accruing loans are included in the average amounts outstanding.
- (3) Average balances based on amortized cost.
- (4) Fees and costs on loans are included in interest income.

| (dollars in thousands)                                       | Nine Months Ended September 30, |   |                            |                    |   |                            |
|--|---------------------------------|---|----------------------------|--------------------|---|----------------------------|
|  | Average<br>Balance              | 2010<br>Interest<br>Income/<br>Expense(1) | Rate<br>Earned/<br>Paid(1) | Average<br>Balance | 2009<br>Interest<br>Income/<br>Expense(1) | Rate<br>Earned/<br>Paid(1) |
| <b>ASSETS</b>  |                                 |   |                            |                    |   |                            |
| Loans (2)(4)   |                                 |   |                            |                    |   |                            |
| Commercial   | \$ 142,976                      | \$ 5,939                                  | 5.55%                      | \$ 150,876         | \$ 6,117                                  | 5.42%                      |
| Real estate construction<br>residential                      | 38,775                          | 1,530                                     | 5.28                       | 35,592             | 1,617                                     | 6.07                       |
| Real estate construction<br>commercial                       | 76,939                          | 2,195                                     | 3.81                       | 59,862             | 2,703                                     | 6.04                       |
| Real estate mortgage<br>residential                          | 225,074                         | 9,648                                     | 5.73                       | 218,075            | 10,756                                    | 6.59                       |
| Real estate mortgage<br>commercial                           | 440,990                         | 19,033                                    | 5.77                       | 508,884            | 20,274                                    | 5.33                       |
| Consumer   | 35,611                          | 2,033                                     | 7.63                       | 33,603             | 1,937                                     | 7.71                       |
| Investment in securities: (3)                                |                                 |   |                            |                    |   |                            |
| U.S. Treasury  | 705                             | 10  | 1.90                       |                    |   |                            |
| Government sponsored<br>enterprises                          | 46,897                          | 946                                       | 2.70                       | 49,133             | 1,419                                     | 3.86                       |
| Asset backed securities                                      | 81,807                          | 2,246                                     | 3.67                       | 62,077             | 1,947                                     | 4.19                       |
| State and municipal  | 33,349                          | 1,344                                     | 5.39                       | 39,725             | 1,646                                     | 5.54                       |
| Restricted investments                                       | 6,427                           | 119                                       | 2.48                       | 8,875              | 110                                       | 1.66                       |
| Federal funds sold   | 174                             |   |                            | 308                |   |                            |
| Interest bearing deposits in<br>other financial institutions | 34,366                          | 64  | 0.25                       | 20,551             | 44  | 0.29                       |
| <b>Total interest earning<br/>assets</b>                     | 1,164,090                       | 45,107                                    | 5.18                       | 1,187,561          | 48,570                                    | 5.47                       |
| All other assets   | 94,499                          |   |                            | 89,073             |   |                            |
| Allowance for loan losses                                    | (13,796)                        |   |                            | (13,303)           |   |                            |
| <b>Total assets</b>  | \$ 1,244,793                    |   |                            | \$ 1,263,331       |   |                            |
| <b>LIABILITIES AND<br/>STOCKHOLDERS<br/>EQUITY</b>           |                                 |   |                            |                    |   |                            |
| NOW accounts   | \$ 173,206                      | \$ 758                                    | 0.59%                      | \$ 139,765         | \$ 902                                    | 0.86%                      |
| Savings  | 51,749                          | 97  | 0.25                       | 45,912             | 106                                       | 0.31                       |
| Money market   | 167,867                         | 842                                       | 0.67                       | 176,562            | 1,382                                     | 1.05                       |
| Time deposits of<br>\$100,000 and over                       | 131,825                         | 1,957                                     | 1.98                       | 140,658            | 3,057                                     | 2.91                       |
| Other time deposits  | 321,827                         | 5,607                                     | 2.33                       | 357,403            | 8,311                                     | 3.11                       |
| <b>Total time deposits</b>                                   | 846,474                         | 9,261                                     | 1.46                       | 860,300            | 13,758                                    | 2.14                       |
|  | 32,963                          | 59  | 0.24                       | 32,483             | 64  | 0.26                       |

|  |                     |                  |              |                     |                  |              |
|--|---------------------|------------------|--------------|---------------------|------------------|--------------|
| Federal funds purchased and securities sold under agreements to repurchase |                     |                  |              |                     |                  |              |
| Subordinated notes   | 49,486              | 1,201            | 3.24         | 49,486              | 1,879            | 5.08         |
| Other borrowed money   | 71,586              | 1,795            | 3.35         | 79,874              | 2,320            | 3.88         |
| <b>Total interest bearing liabilities</b>                                  | <b>1,000,509</b>    | <b>12,316</b>    | <b>1.65</b>  | <b>1,022,143</b>    | <b>18,021</b>    | <b>2.36</b>  |
| Demand deposits  | 128,617             |                  |              | 123,206             |                  |              |
| Other liabilities  | 6,744               |                  |              | 10,606              |                  |              |
| <b>Total liabilities</b>   | <b>1,135,870</b>    |                  |              | <b>1,155,955</b>    |                  |              |
| Stockholders equity  | 108,923             |                  |              | 107,376             |                  |              |
| <b>Total liabilities and stockholders equity</b>                           | <b>\$ 1,244,793</b> |                  |              | <b>\$ 1,263,331</b> |                  |              |
| <b>Net interest income (FTE)</b>   |                     | <b>\$ 32,791</b> |              |                     | <b>\$ 30,549</b> |              |
| <b>Net interest spread</b>   |                     |                  | <b>3.53%</b> |                     |                  | <b>3.11%</b> |
| <b>Net interest margin</b>   |                     |                  | <b>3.77%</b> |                     |                  | <b>3.44%</b> |

(1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 35%, net of nondeductible interest expense. Such adjustments totaled \$507,000 and \$565,000 for the nine months ended September 30, 2010 and 2009, respectively.

(2) Non-accruing loans are included in the average amounts outstanding.

(3) Average balances based on amortized cost.

(4) Fees and costs on loans are included in interest income.

**Comparison of the three months ended September 30, 2010 and 2009**

Financial results for the third quarter of 2010 compared to 2009 included an increase in net interest income, on a tax equivalent basis of \$394,000, or 3.7%. Average interest-earning assets decreased \$33,022,000, or 2.8%, to \$1,146,955,000 for the three months ended September 30, 2010 compared to \$1,179,977,000 for the three months ended September 30, 2009. Average interest bearing liabilities decreased \$33,153,000, or 3.3%, to \$977,993,000 for the three months ended September 30, 2010 compared to \$1,011,146,000 for the three months ended September 30, 2009.

Average loans outstanding decreased \$63,291,000 or 6.3% to \$938,961,000 for the three months ended 2010 compared to \$1,002,252,000 for the three months ended September 30, 2009. See the *Lending and Credit Management* section below for further discussion. The following is a summary of the changes in average loan balance by major category:

| (Dollars in thousands)               | Three Months Ended September 30, |                     |                    | %<br>Change   |
|--------------------------------------|----------------------------------|---------------------|--------------------|---------------|
|                                      | 2010                             | 2009                | \$ Change          |               |
| <b>Average loans:</b>                |                                  |                     |                    |               |
| Commercial                           | \$ 136,613                       | \$ 149,059          | \$ (12,446)        | (8.3)%        |
| Real estate construction residential | 38,374                           | 43,026              | (4,652)            | (10.8)        |
| Real estate construction commercial  | 76,356                           | 76,115              | 241                | 0.3           |
| Real estate mortgage residential     | 213,774                          | 277,626             | (63,852)           | (23.0)        |
| Real estate mortgage commercial      | 439,261                          | 421,172             | 18,089             | 4.3           |
| Consumer                             | 34,583                           | 35,254              | (671)              | (1.9)         |
| <b>Total</b>                         | <b>\$ 938,961</b>                | <b>\$ 1,002,252</b> | <b>\$ (63,291)</b> | <b>(6.3)%</b> |

Average investment securities and federal funds sold increased \$10,899,000, or 7.1%, to \$165,461,000 for the three months ended September 30, 2010 compared to \$154,562,000 for the three months ended September 30, 2009.

Average interest bearing deposits increased \$21,935,000 to \$36,223,000 for the three months ended September 30, 2010 compared to \$14,288,000 for the three months ended September 30, 2009. See the *Liquidity Management* section below for further discussion.

The overall decrease in average interest bearing liabilities was due to a decrease in time deposits and Federal funds purchased and securities sold under agreements to repurchase. Average time deposits decreased \$25,927,000, or 3.0%, to \$827,714,000 for the three months ended September 30, 2010 compared to \$853,641,000 for the three months ended September 30, 2009. Average Federal funds purchased and securities sold under agreements to repurchase decreased \$4,267,000, or 11.7%, to \$32,149,000 for the three months ended September 30, 2010 compared to \$36,416,000 for the three months ended September 30, 2009. The decrease primarily reflects a decrease in term repurchase agreement average balances.

**Comparison of the nine months ended September 30, 2010 and 2009**

Financial results for the nine months ended September 30, 2010 compared to 2009 included an increase in net interest income, on a tax equivalent basis of \$2,242,000, or 7.3%. Average interest-earning assets decreased \$23,471,000, or 2.0%, to \$1,164,090,000 for the nine months ended September 30, 2010 compared to \$1,187,561,000 for the nine months ended September 30, 2009. Average interest bearing liabilities decreased \$21,634,000, or 2.1%, to \$1,000,509,000 for the nine months ended September 30, 2010 compared to \$1,022,143,000 for the nine months ended September 30, 2009.

Average loans outstanding decreased \$46,527,000 or 4.6% to \$960,365,000 for the nine months ended 2010 compared to \$1,006,892,000 for the nine months ended September 30, 2009. See the *Lending and Credit Management* section below for further discussion. The following is a summary of the changes in average loan balance by major category:

| <i>(Dollars in thousands)</i>        | <b>Nine Months Ended September 30,</b> |                     |                    | <b>%<br/>Change</b> |
|--------------------------------------|--|---------------------|--------------------|---------------------|
|                                      | <b>2010</b>                            | <b>2009</b>         | <b>\$ Change</b>   |                     |
| <b>Average loans:</b>                |  |                     |                    |                     |
| Commercial                           | \$ 142,976                             | \$ 150,876          | \$ (7,900)         | (5.2)%              |
| Real estate construction residential | 38,775                                 | 35,592              | 3,183              | 8.9                 |
| Real estate construction commercial  | 76,939                                 | 59,862              | 17,077             | 28.5                |
| Real estate mortgage residential     | 225,074                                | 218,075             | 6,999              | 3.2                 |
| Real estate mortgage commercial      | 440,990                                | 508,884             | (67,894)           | (13.3)              |
| Consumer                             | 35,611                                 | 33,603              | 2,008              | 6.0                 |
| <b>Total</b>                         | <b>\$ 960,365</b>                      | <b>\$ 1,006,892</b> | <b>\$ (46,527)</b> | <b>(4.6)%</b>       |

Average investment securities and federal funds sold increased \$11,689,000, or 7.7%, to \$162,932,000 for the nine months ended September 30, 2010 compared to \$151,243,000 for the nine months ended September 30, 2009. Average interest bearing deposits increased \$13,815,000 to \$34,366,000 for the nine months ended September 30, 2010 compared to \$20,551,000 for the nine months ended September 30, 2009. See the *Liquidity Management* section below for further discussion.

The overall decrease in average interest bearing liabilities was due to a decrease in time deposits and other borrowed money. Average time deposits decreased \$13,826,000, or 1.6%, to \$846,474,000 for the nine months ended September 30, 2010 compared to \$860,300,000 for the nine months ended September 30, 2009. Average other borrowed money decreased \$8,288,000, or 10.4%, to \$71,586,000 for 2010 compared to \$79,874,000 for 2009. The decrease in 2010 reflects a net decrease in Federal Home Loan Bank advances.

**Rate and volume analysis**

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

|  | Three Months Ended September<br>30,<br>2010 vs. 2009 |                   |                 | Nine Months Ended September 30,<br>2010 vs. 2009 |                   |                 |
|--|--|-------------------|-----------------|--|-------------------|-----------------|
|  | Total<br>Change                                      | Average<br>Volume | Average<br>Rate | Total<br>Change                                  | Average<br>Volume | Average<br>Rate |
| <i>(Dollars In thousands)</i>  |  |                   |                 |  |                   |                 |
| <b>Interest income on a fully taxable equivalent basis:</b>                |  |                   |                 |  |                   |                 |
| Loans: (1) (3)   |  |                   |                 |  |                   |                 |
| Commercial   | \$ (111)   | \$ (170)          | \$ 59           | \$ (178)   | \$ (320)          | \$ 142          |
| Real estate construction residential                                       | 28   | (57)              | 85              | (87)   | 137               | (224)           |
| Real estate construction commercial  | (74)   | 3                 | (77)            | (508)  | 647               | (1,155)         |
| Real estate mortgage residential   | (382)  | (895)             | 513             | (1,108)  | 336               | (1,444)         |
| Real estate mortgage commercial  | (520)  | 282               | (802)           | (1,241)  | (2,844)           | 1,603           |
| Consumer   | (44)   | (13)              | (31)            | 96   | 115               | (19)            |
| Investment securities:   |  |                   |                 |  |                   |                 |
| U.S. Treasury  | 5  |                   | 5               | 10   |                   | 10              |
| Government sponsored entities  | (168)  | 4                 | (172)           | (473)  | (62)              | (411)           |
| Asset backed securities  | 80   | 163               | (83)            | 299  | 564               | (265)           |
| State and municipal(2)   | (125)  | (106)             | (19)            | (302)  | (258)             | (44)            |
| Restricted investments   | (20)   | (15)              | (5)             | 9  | (35)              | 44              |
| Federal funds sold   |  |                   |                 |  |                   |                 |
| Interest bearing deposits in other financial institutions                  | 17   | 17                |                 | 20   | 27                | (7)             |
| <b>Total interest income</b>   | <b>(1,314)</b>                                       | <b>(787)</b>      | <b>(527)</b>    | <b>(3,463)</b>                                   | <b>(1,693)</b>    | <b>(1,770)</b>  |
| <b>Interest expense:</b>   |  |                   |                 |  |                   |                 |
| NOW accounts   | (42)   | 43                | (85)            | (144)  | 186               | (330)           |
| Savings  | (2)  | 4                 | (6)             | (9)  | 12                | (21)            |
| Money market   | (136)  | (27)              | (109)           | (540)  | (65)              | (475)           |
| Time deposits of 100,000 and over  | (355)  | (86)              | (269)           | (1,100)  | (182)             | (918)           |
| Other time deposits  | (774)  | (202)             | (572)           | (2,704)  | (768)             | (1,936)         |
| Federal funds purchased and securities sold under agreements to repurchase | (3)  | (3)               |                 | (5)  | 1                 | (6)             |



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|  |                |                 |                |                 |                 |                 |
|--|----------------|-----------------|----------------|-----------------|-----------------|-----------------|
| Subordinated notes   | (236)          |                 | (236)          | (678)           |                 | (678)           |
| Other borrowed money   | (160)          | (27)            | (133)          | (525)           | (227)           | (298)           |
| <b>Total interest expense</b>                                  | <b>(1,708)</b> | <b>(298)</b>    | <b>(1,410)</b> | <b>(5,705)</b>  | <b>(1,043)</b>  | <b>(4,662)</b>  |
| <b>Net interest income on a fully taxable equivalent basis</b> | <b>\$ 394</b>  | <b>\$ (489)</b> | <b>\$ 883</b>  | <b>\$ 2,242</b> | <b>\$ (650)</b> | <b>\$ 2,892</b> |

(1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 35%, net of nondeductible interest expense. Such adjustments totaled \$161,000 and \$507,000, and \$189,000 and \$565,000 for the three and nine months ended September 30, 2010 and 2009, respectively.

(2) Non-accruing loans are included in the average amounts outstanding.

(3) Fees and costs on loans are included in interest income.

Net interest income on a fully taxable equivalent basis increased \$394,000, or 3.7%, to \$11,019,000 for the three months ended September 30, 2010 compared to \$10,625,000 for the three months ended September 30, 2009. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) increased from 3.57% for the three months ended September 30, 2009 to 3.81% for the three months ended September 30, 2010. This increase is primarily the result of a decrease in average earning liabilities. Our Company's net interest spread increased from 3.26% during the three months ended September 30, 2009 to 3.58% during the same time period in 2010. While our Company was able to decrease the rate paid on interest bearing liabilities to 1.53% during the three months ended September 30, 2010 from 2.15% during the same time period in 2009, this decrease was partially offset by a decrease in the rates earned on interest bearing assets from 5.41% in 2009 to 5.11% in 2010.

Net interest income on a fully taxable equivalent basis increased \$2,242,000, or 7.3%, to \$32,791,000 for the nine months ended September 30, 2010 compared to \$30,549,000 for the nine months ended September 30, 2009. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) increased from 3.44% for the nine months ended September 30, 2009 to 3.77% for the nine months ended September 30, 2010. This increase is primarily the result of a decrease in average earning liabilities. Our Company's net interest spread increased from 3.11% during the nine months ended September 30, 2009 to 3.53% during the same time period in 2010. While our Company was able to decrease the rate paid on interest bearing liabilities to 1.65% during the nine months ended September 30, 2010 from 2.36% during the same time period in 2009, this decrease was partially offset by a decrease in the rates earned on interest bearing assets from 5.47% in 2009 to 5.18% in 2010.

### **Non-interest Income and Expense**

#### **Non-interest income**

|   | <b>Three Months<br/>Ended September 30,</b> |                 |               |               | <b>Nine Months<br/>Ended September 30,</b> |                 |                 |               |
|---|---|-----------------|---------------|---------------|--|-----------------|-----------------|---------------|
|   |   |                 | <b>\$</b>     | <b>%</b>      |  |                 | <b>\$</b>       | <b>%</b>      |
| <i>(Dollars in thousands)</i>                   | <b>2010</b>                                 | <b>2009</b>     | <b>Change</b> | <b>Change</b> | <b>2010</b>                                | <b>2009</b>     | <b>Change</b>   | <b>Change</b> |
| <b>Non-interest Income</b>                      |   |                 |               |               |  |                 |                 |               |
| Service charges on deposit                      | \$ 1,427                                    | \$ 1,547        | \$ (120)      | (7.8)%        | \$ 4,150                                   | \$ 4,380        | \$ (230)        | (5.3)%        |
| Trust department income                         | 187   | 238             | (51)          | (21.4)        | 567  | 624             | (57)            | (9.1)         |
| Gain on sales of mortgage loans                 | 1,011                                       | 489             | 522           | 106.7         | 1,533                                      | 2,437           | (904)           | (37.1)        |
| Other   | 285   | 326             | (41)          | (12.6)        | 1,116                                      | 732             | 384             | 52.5          |
| <b>Total non-interest income</b>                | <b>\$ 2,910</b>                             | <b>\$ 2,600</b> | <b>\$ 310</b> | <b>11.9%</b>  | <b>\$ 7,366</b>                            | <b>\$ 8,173</b> | <b>\$ (807)</b> | <b>(9.9)%</b> |
| Non-interest income as a % of total revenue*    | 21.1%                                       | 19.9%           |               |               | 18.6%                                      | 21.4%           |                 |               |
| Total revenue per full time equivalent employee | \$ 40.1                                     | \$ 37.9         |               |               | \$ 115.6                                   | \$ 110.9        |                 |               |

\* Total revenue is calculated as net interest income plus non-interest income

#### **Three Months Ended September 30, 2010 and 2009**

Noninterest income for the three months ended September 30, 2010 was \$2,910,000 compared to \$2,600,000 for the three months ended September 30, 2009, resulting in a \$310,000, or 11.9%, increase. The increase was primarily the result of a \$522,000 increase in the gains on sales of mortgage loans due to an increase in refinancing activity during the third quarter of 2010 compared to the same time period in 2009.

#### **Nine Months Ended September 30, 2010 and 2009**

Noninterest income for the nine months ended September 30, 2010 was \$7,366,000 compared to \$8,173,000 for the nine months ended September 30, 2009, resulting in an \$807,000, or 9.9%, decrease. Although third quarter experienced a substantial increase in real estate refinancing activity, the decrease in year to date noninterest income was primarily the result of a \$904,000 decrease in the gains on sales of mortgage loans in comparison to 2009. Partially offsetting this decrease, other income increased \$384,000, or 52.5%, to \$1,116,000 compared to the prior period. This was primarily due to a \$212,000 increase in credit card income, of which \$167,000 was due to a

nonmaterial correction and an \$186,000 increase in real estate servicing fees.

**Non-interest expense**

| <i>(Dollars in thousands)</i>                                    | <b>Three Months<br/>Ended September 30,</b> |                 |                      |                     | <b>Nine Months<br/>Ended September 30,</b> |                  |                      |                     |
|--|---|-----------------|----------------------|---------------------|--|------------------|----------------------|---------------------|
|  | <b>2010</b>                                 | <b>2009</b>     | <b>\$<br/>Change</b> | <b>%<br/>Change</b> | <b>2010</b>                                | <b>2009</b>      | <b>\$<br/>Change</b> | <b>%<br/>Change</b> |
| <b>Non-interest Expense</b>                                      |   |                 |                      |                     |  |                  |                      |                     |
| Salary expense   | \$ 3,369                                    | \$ 3,400        | \$ (31)              | (0.9)%              | \$ 10,440                                  | \$ 10,191        | \$ 249               | 2.4%                |
| Employee benefits  | 887   | 1,054           | (167)                | (15.8)              | 3,024                                      | 3,213            | (189)                | (5.9)               |
| Occupancy expense,<br>net  | 655   | 600             | 55                   | 9.2                 | 1,881                                      | 1,763            | 118                  | 6.7                 |
| Furniture and<br>equipment expense                               | 473   | 507             | (34)                 | (6.7)               | 1,499                                      | 1,794            | (295)                | (16.4)              |
| FDIC insurance<br>assessment                                     | 443   | 422             | 21                   | 5.0                 | 1,288                                      | 2,086            | (798)                | (38.3)              |
| Legal, examination,<br>and professional fees                     | 349   | 312             | 37                   | 11.9                | 932  | 985              | (53)                 | (5.4)               |
| Advertising and<br>promotion                                     | 311   | 301             | 10                   | 3.3                 | 886  | 901              | (15)                 | (1.7)               |
| Postage, printing, and<br>supplies                               | 300   | 271             | 29                   | 10.7                | 875  | 834              | 41                   | 4.9                 |
| Processing expense   | 854   | 845             | 9                    | 1.1                 | 2,561                                      | 2,538            | 23                   | 0.9                 |
| Other real estate<br>expense                                     | 882   | 240             | 642                  | 267.5               | 2,895                                      | 575              | 2,320                | 403.5               |
| Other  | 843   | 1,088           | (245)                | (22.5)              | 2,535                                      | 2,816            | (281)                | (10.0)              |
| <b>Total non-interest<br/>expense</b>                            | <b>\$ 9,366</b>                             | <b>\$ 9,040</b> | <b>\$ 326</b>        | <b>3.6%</b>         | <b>\$ 28,816</b>                           | <b>\$ 27,696</b> | <b>\$ 1,120</b>      | <b>4.0%</b>         |
| Efficiency ratio   | 68.0%                                       | 69.3%           |                      |                     | 72.7%                                      | 72.6%            |                      |                     |
| Salaries and benefits as<br>a % of total<br>non-interest expense | 45.4%                                       | 49.3%           |                      |                     | 46.7%                                      | 48.4%            |                      |                     |
| Number of full-time<br>equivalent employees                      |   |                 |                      |                     | 343  | 344              |                      |                     |

**Three Months Ended September 30, 2010 and 2009**

Noninterest expense for the three months ended September 30, 2010 was \$9,366,000 compared to \$9,040,000 for the three months ended September 30, 2009 resulting in a \$326,000, or 3.6%, increase. Other real estate expense increased \$642,000, or 267.5%, partially offset by a decrease in employee benefits of \$167,000, or 15.8%, and a decrease in other expenses of \$245,000, or 22.5%. The increase in other real estate expense reflects a \$644,000 increase in impairment charges and net losses on sales of foreclosed property during the third quarter of 2010 compared to the third quarter of 2009. The decrease in employee benefits expense was primarily due to a \$171,000 decrease in our Company's profit sharing accrual. The decrease in third quarters 2010 other expenses is primarily a result a \$178,000 donation of a foreclosed property during September of 2009.

**Nine Months Ended September 30, 2010 and 2009**

Noninterest expense for the nine months ended September 30, 2010 was \$28,816,000 compared to \$27,696,000 for the nine months ended September 30, 2009 resulting in a \$1,120,000, or 4.0%, increase. Other real estate expense

increased \$2,320,000, or 403.5%, partially offset by a decrease in furniture and equipment expenses of \$295,000, or 16.4%, and a decrease in Federal Deposit Insurance Corporation (FDIC) insurance assessment of \$798,000, or 38.3%. The increase in other real estate expense reflects expenses incurred on the increase in our Company's foreclosed property during 2010. Impairment charges and net losses on sales of foreclosed property increased \$1,849,000 during 2010 compared to 2009. Expenses to maintain and prepare these properties for sale also increased \$500,000 during 2010. The decrease in furniture and equipment expense primarily was due to an \$186,000 net loss on the sale of one of our Company's branch buildings in September of 2009. The decrease in the FDIC insurance assessment is a result of a decrease in the estimated expense accrued during 2010 in comparison to 2009 and an increase in special assessments during 2009.

***Income Taxes***

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 27.2% for the three months ended September 30, 2010 compared to 30.6% for the three months ended September 30, 2009. The effective tax rate during the third quarter of 2010 reflects the increase in tax-exempt income as a percentage of total taxable income.

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 27.6% for the nine months ended September 30, 2010 compared to 31.2% for the nine months ended September 30, 2009. The effective tax rate during for the nine months ended September 30, 2010 reflects the increase in tax-exempt income as a percentage of total taxable income.

### ***Lending and Credit Management***

Interest earned on the loan portfolio is a primary source of interest income for our Company. Net loans represented 75.7% of total assets as of September 30, 2010 compared to 79.0% as of December 31, 2009.

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

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

| <i>(In thousands)</i>                   | <b>September 30,</b> |               | <b>December 31,</b> |               |
|---|----------------------|---------------|---------------------|---------------|
|   | <b>2010</b>          |               | <b>2009</b>         |               |
|   | <b>Amount</b>        | <b>%</b>      | <b>Amount</b>       | <b>%</b>      |
| Commercial, financial, and agricultural | \$ 132,920           | 14.2%         | \$ 151,399          | 15.3%         |
| Real estate construction residential    | 38,229               | 4.1           | 38,841              | 3.9           |
| Real estate construction commercial     | 76,587               | 8.2           | 77,937              | 7.9           |
| Real estate mortgage residential        | 217,802              | 23.3          | 232,332             | 23.4          |
| Real estate mortgage commercial         | 433,930              | 46.5          | 453,975             | 45.8          |
| Installment loans to individuals        | 33,822               | 3.6           | 36,966              | 3.7           |
| Deferred fees                           | 166                  | 0.0           | 164                 | 0.0           |
| <b>Total loans</b>                      | <b>\$ 933,456</b>    | <b>100.0%</b> | <b>\$ 991,614</b>   | <b>100.0%</b> |

Our Company's loan portfolio decreased \$58,158,000, or 5.9%, from December 31, 2009 to September 30, 2010. This decrease was primarily a result of a decrease in commercial loans of \$18,480,000, or 12.2%, a decrease in real estate mortgage residential loans of \$14,530,000, or 6.3%, a decrease in real estate mortgage commercial loans of \$20,045,000, or 4.4%, and a decrease in individual consumer loans of \$3,144,000, or 8.5%. The decrease in commercial loans and real estate mortgage loans primarily reflects the payoff of three large commercial credits and two large real estate mortgage loans. The decrease in individual consumer loans reflects the payoff of one large consumer loan which was secured by a Bank certificate of deposit. Also contributing to the decrease in total loans were gross charge-offs of \$8,466,000 and \$12,665,000 of assets transferred from loans to other real estate owned and repossessed assets. During the current down-turn in the economy, management continues to focus on the improvement of asset quality. Management has tightened underwriting standards and is focused on lending to credit worthy borrowers with the capacity to service the debts. Where appropriate, management actively works with existing borrowers to modify loan terms and conditions in order to assist the borrowers in servicing their debt obligations to our Company. The decrease in lending activities in the real estate construction market also reflects the slow down in the housing industry and residential construction industry as well as foreclosures on various residential construction properties. Construction lending will continue to be closely monitored.

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

Our Company generally does not retain long-term fixed rate residential mortgage loans in its portfolio. Fixed rate loans conforming to standards required by the secondary market are offered to qualified borrowers, but are not funded until our Company has a non-recourse purchase commitment from the secondary market at a predetermined price. At September 30, 2010 our Company was servicing approximately \$285,888,000 of loans sold to the secondary market.



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

Management along with senior loan committee, and internal loan review, formally review all loans in excess of certain dollar amounts (periodically established) at least annually. Currently, loans in excess of \$2,000,000 in aggregate and all adversely classified credits identified by management as containing more than usual risk are reviewed. In addition, loans below the above scope are reviewed on a sample basis. On a monthly basis, the senior loan committee reviews and reports to the Board of Directors past due, classified, and watch list loans in order to classify or reclassify loans as loans requiring attention, substandard, doubtful, or loss. During this review, management also determines which loans should be considered impaired. Management follows the guidance provided in the FASB's ASC Topic 310, *Accounting by Creditors for Impairment of a Loan*, in identifying and measuring loan impairment. If management determines that it is probable that all amounts due on a loan will not be collected under the original terms of the loan agreement, the loan is considered to be impaired. These loans are evaluated individually for impairment, and in conjunction with current economic conditions and loss experience, allowances are estimated based on the fair value as further discussed below. Loans not individually evaluated are aggregated and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type, delinquencies, current economic conditions, loan risk ratings and industry concentration. Management believes, but there can be no assurance, that these procedures keep management informed of possible problem loans. Based upon these procedures, both the allowance and provision for loan losses are adjusted to maintain the allowance at a level considered adequate by management for probable losses inherent in the loan portfolio.

#### **Provision and Allowance for Loan Losses**

The provision for loan losses increased \$2,701,000 or 61.3% to \$7,105,000 for the nine months ended September 30, 2010 compared to \$4,404,000 for the nine months ended September 30, 2009. The current economy has contributed to the deterioration of collateral values. Our Company has taken an active approach to obtain current appraisals and has adjusted the provision to reflect the amounts management determined necessary to maintain the allowance for loan losses at a level adequate to cover probable losses in the loan portfolio. However, due to charge offs taken during the first nine months of 2010, the allowance for loan losses decreased to \$13,954,000 or 1.5% of loans outstanding at September 30, 2010 compared to \$14,797,000 or 1.5% of loans outstanding at December 31, 2009. The allowance for loan losses expressed as a percentage of nonperforming loans was 21.1% at September 30, 2010 and 34.9% at December 31, 2009.

The following table summarizes loan loss experience for the periods indicated:

| <i>(Dollars in thousands)</i>           | <b>Three Months Ended<br/>September 30,</b> |                 | <b>Nine Months Ended<br/>September 30,</b> |                 |
|---|---|-----------------|--|-----------------|
|   | <b>2010</b>                                 | <b>2009</b>     | <b>2010</b>                                | <b>2009</b>     |
| <b>Provision for loan losses</b>        | \$ 2,450                                    | \$ 1,250        | \$ 7,105                                   | \$ 4,404        |
| <b>Net loan charge-offs:</b>            |   |                 |  |                 |
| Commercial, financial, and agricultural | 333   | 157             | 1,437                                      | 417             |
| Real estate construction – residential  | (1)   | 427             | 258  | 988             |
| Real estate construction – commercial   |   |                 | 101  | 289             |
| Real estate mortgage – residential      | 306   | 256             | 3,625                                      | 948             |
| Real estate mortgage – commercial       | 37  | 115             | 2,374                                      | 321             |
| Installment loans to individuals        | 53  | 72              | 153  | 180             |
| <b>Total net loan charge-offs</b>       | <b>\$ 728</b>                               | <b>\$ 1,027</b> | <b>\$ 7,948</b>                            | <b>\$ 3,143</b> |



As shown in the table above, our Company experienced net loan charge-offs of \$7,948,000 during the first nine months of 2010 and \$3,143,000 during the first nine months of 2009. Net charge offs on commercial, financial, and agricultural loans increased \$1,020,000 from September 30, 2009 to September 30, 2010, and was primarily due to three write-downs taken on two loans to reflect current collateral values. Net charge offs on real estate mortgage residential properties increased \$2,677,000 from September 30, 2009 to September 30, 2010 and was primarily due to write-downs taken on foreclosed properties, from two significant customer relationships, to reflect current collateral values. Net charge offs on real estate mortgage commercial properties increased \$2,053,000 from September 30, 2009 to September 30, 2010 and was primarily due to write-downs taken on five loans to reflect current collateral values. The

ratio of annualized total net loan charge-offs to total average loans was 0.83% at September 30, 2009 compared to 0.31% at September 30, 2010.

Nonperforming loans, defined as loans on nonaccrual status, loans 90 days or more past due and still accruing interest, and restructured troubled loans totaled \$65,879,000 or 7.06% of total loans at September 30, 2010 compared to \$42,347,000 or 4.27% of total loans at December 31, 2009.

The following table summarizes our Company's nonperforming assets at the dates indicated:

| <i>(Dollars in thousands)</i>   | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|-----------------------------------|----------------------------------|
| <b>Nonaccrual loans:</b>  |                                   |                                  |
| Commercial, financial, and agricultural                                       | \$ 1,854                          | \$ 2,067                         |
| Real estate construction residential  | 3,086                             | 2,678                            |
| Real estate construction commercial   | 22,580                            | 9,277                            |
| Real estate mortgage residential  | 6,457                             | 6,692                            |
| Real estate mortgage commercial   | 15,769                            | 13,161                           |
| Installment loans to individuals  | 101                               | 279                              |
| <b>Total nonaccrual loans</b>   | <b>49,847</b>                     | <b>34,154</b>                    |
| <b>Loans contractually past due 90 days or more and still accruing:</b>       |                                   |                                  |
| Commercial, financial, and agricultural                                       |                                   | 2                                |
| Real estate mortgage residential  | 73                                |                                  |
| Installment loans to individuals  | 1                                 |                                  |
| <b>Total loans contractually past -due 90 days or more and still accruing</b> | <b>74</b>                         | <b>2</b>                         |
| <b>Troubled debt restructured loans</b>                                       | <b>15,958</b>                     | <b>8,191</b>                     |
| <b>Total nonperforming loans</b>  | <b>65,879</b>                     | <b>42,347</b>                    |
| Other real estate and repossessions   | 10,012                            | 8,491                            |
| <b>Total nonperforming assets</b>   | <b>\$ 75,891</b>                  | <b>\$ 50,838</b>                 |
| Loans   | \$ 933,456                        | \$ 991,614                       |
| Allowance for loan losses to loans  | 1.49%                             | 1.49%                            |
| Nonperforming loans to loans  | 7.06%                             | 4.27%                            |
| Allowance for loan losses to nonperforming loans                              | 21.18%                            | 34.94%                           |
| Nonperforming assets to loans and foreclosed assets                           | 8.04%                             | 5.08%                            |

It is our Company's policy to discontinue the accrual of interest income on loans when the full collection of principal or interest is in doubt, or when the payment of principal or interest has become contractually 90 days past due unless the obligation is both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectibles of such principal; otherwise, such receipts are recorded as interest income. Interest on nonaccrual loans, which would have been recorded under the original terms of the loans, was approximately \$1,874,000 and \$1,152,000 for the nine months ended September 30, 2010 and 2009, respectively. Approximately \$11,000 and \$42,000 was recorded as interest income on such loans for the nine months ended September 30, 2010 and 2009, respectively.

Total non-accrual loans at September 30, 2010 increased \$15,693,000 from December 31, 2009. The increase resulted primarily from an increase of \$13,303,000 in real estate construction - commercial non-accrual loans. This increase primarily represents four commercial customers with balances totaling \$15,886,000. Although our non-accrual loans significantly increased from \$34,154,000 at December 31, 2009 to \$49,847,000 at September 30, 2010, total impaired loans decreased \$7,384,000.

Loans past due 90 days and still accruing interest increased \$72,000 from December 31, 2009 to September 30, 2010. Foreclosed real estate and other repossessions increased \$1,521,000 to \$10,012,000. At September 30, 2010, loans classified as troubled debt restructured loans (TDR) totaled \$22,457,000, of which \$6,499,000 was on non-accrual status and \$15,958,000 was on accrual status. At December 31, 2009, loans classified as TDR totaled \$11,233,000, of which \$3,042,000 was on non-accrual status and \$8,191,000 was on accrual status. The increase in TDR loans is primarily reflected by one large hotel credit of \$11,091,000.

The ratio of nonperforming loans to loans increased from 4.27% at December 31, 2009 to 7.06% at September 30, 2010. Our Company has experienced an increase in its loan delinquencies much like the rest of the banking industry as current economic conditions negatively impact our borrowers' ability to keep their debt payments current.

The increase in the levels of charge offs has contributed to the decrease in the ratio of allowance for loan losses to nonperforming loans from 41.11% at September 30, 2009 to 34.94% at December 31, 2009, and to 21.18% at September 30, 2010. Management believes that based on detailed analysis of each nonperforming credit and the value of any associated collateral that the allowance for loan losses at September 30, 2010 is sufficient to cover probable losses in the nonperforming loans.

The fair value of impaired loans are generally based on market prices for loans with similar collateral determined through independent appraisals, the fair value of the collateral for a collateral-dependent loan, or by discounting the total expected future cash flows. Once the fair value of collateral has been determined and any impairment amount calculated, a specific reserve allocation is made. At September 30, 2010, \$7,798,000 of our Company's allowance for loan losses was allocated to impaired loans totaling approximately \$66,483,000 compared to \$6,415,000 of our Company's allowance for loan losses was allocated to impaired loans totaling approximately \$73,877,000 at December 31, 2009. Based on detailed analysis of all impaired loans, management has determined that \$31,767,000, or 48%, of impaired loans require no reserve allocation at September 30, 2010 compared to \$47,572,000, or 64%, at December 31, 2009. Management believes the excess value in the collateral was sufficient at September 30, and December 31, and these loans did not require additional reserves.

In addition to nonaccrual loans and TDRs at September 30, 2010 included in the table above, which were considered impaired, management has identified additional loans totaling approximately \$678,000 which were not included in the table above but are considered by management to be impaired compared to \$31,522,000 at December 31, 2009. Management has allocated \$524,000 of reserves for these credits at September 31, 2010.

As of September 30, 2010 and December 31, 2009 approximately \$18,640,000 and \$15,944,000, respectively, of loans not included in the table above have been classified by management as having more than normal risk which raised doubts as to the ability of the borrower to comply with present loan repayment terms. The \$2,696,000 increase in classified loans is the result of several borrowers who have experienced cash flow problems as well as some deterioration in collateral value. Management elected to allocate non-specific reserves to these credits based upon the inherent risk present.

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

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

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

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

The underlying assumptions, estimates and assessments used by management to determine these components are continually evaluated and updated to reflect management's current view of overall economic conditions and relevant factors impacting credit quality and inherent losses. Changes in such estimates could significantly impact the

allowance and provision for credit losses. Our Company could experience credit losses that are different from the current estimates made by management.

The following table is a summary of the allocation of the allowance for loan losses as of the dates indicated:

| <i>(Dollars in thousands)</i>                             | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|-----------------------------------|----------------------------------|
| Allocation of allowance for loan losses at end of period: |                                   |                                  |
| Commercial, financial, and agricultural                   | \$ 2,123                          | \$ 2,773                         |
| Real estate construction residential                      | 995                               | 348                              |
| Real estate construction commercial                       | 3,875                             | 1,740                            |
| Real estate mortgage residential                          | 2,700                             | 3,488                            |
| Real estate mortgage commercial                           | 3,259                             | 4,693                            |
| Installment loans to individuals                          | 262                               | 380                              |
| Unallocated   | 740                               | 1,375                            |
| <b>Total</b>  | <b>\$ 13,954</b>                  | <b>\$ 14,797</b>                 |

At September 30, 2010, management allocated \$13,214,000 of the \$13,954,000 total allowance for loan losses to specific loans and loan categories and \$740,000 was unallocated. At December 31, 2009, management allocated \$13,422,000 of the \$14,497,000 total allowance for loan losses to specific loans and loan categories and \$1,375,000 was unallocated. The decrease in the portion of the allowance for loan losses related to non asset-specific reserves is the result of management analyzing and assessing this portion of the allowance for loan losses on a more detailed level by homogeneous loan categories for loans not considered impaired. Such analysis measured reserve requirements based on historical loss experiences of loans in those individual categories and therefore provided a more robust reserve methodology. Such reserve methodology considers the loss experience for certain types of loans and loan grades for the past nine quarters. Given the enhancements to the methodology for historical loss experience, the unallocated reserves for certain qualitative factors have been reduced accordingly. Management considers the non asset-specific portion of the allowance for loan losses at September 30, 2010 to be adequate as part of the overall reserves to cover losses in the loan portfolio not identified by specific loss methodologies.

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

#### ***Financial Condition***

Total assets decreased \$21,404,000 or 1.7% to \$1,215,066,000 at September 30, 2010 compared to \$1,236,470,000 at December 31, 2009. Earning assets at September 30, 2010 were \$1,140,114,000 and consisted of 81.9% in loans and 14.5% in available for sale investment securities, compared to 85.9% and 13.3%, respectively at December 31, 2009. Total liabilities decreased \$23,554,000 or 2.1% to \$1,105,145,000 compared to \$1,128,699,000 at December 31, 2009. Stockholders equity increased \$2,150,000 or 2.0% to \$109,921,000 compared to \$107,771,000 at December 31, 2009.

As described in further detail in the Lending and Credit Management section above, during the first nine months of 2010, total period end loans decreased \$58,158,000 to \$933,456,000 at September 30, 2010 compared to \$991,614,000 at December 31, 2009. This decrease was primarily the result of an \$18,480,000 decrease in commercial loans, an \$14,530,000 decrease in real estate - residential loans, a \$20,045,000 decrease in real estate commercial loans, and a \$3,144,000 decrease in consumer loans.

Investment in debt securities classified as available-for-sale, excluding fair value adjustments, increased \$9,960,000 or 6.6% to \$160,569,000 at September 30, 2010 compared to \$150,609,000 at December 31, 2009. The net increase primarily consisted of an increase in mortgage-backed securities of \$14,851,000, an increase in federal

agency securities of \$2,225,000, partially offset by an \$8,116,000 reduction in municipal obligations.

Total deposits decreased \$5,749,000 or 0.6% to \$950,574,000 at September 30, 2010 compared to \$956,323,000 at December 31, 2009. The increase is primarily a result of an decrease in public fund deposits.

Federal funds purchased and securities sold under agreements to repurchase decreased \$5,185,000 or 14.2% to \$31,460,000 at September 30, 2010 compared to \$36,645,000 at December 31, 2009. The decrease mostly consisted of a \$4,980,000 decrease in federal funds purchased compared to December 31, 2009.

Other borrowed money decreased \$12,149,000 or 15.3% to \$67,168,000 at September 30, 2010 compared to \$79,317,000 at December 31, 2009. The decrease reflects the net repayment of Federal Home Loan Bank advances.

Stockholders' equity increased \$2,150,000 or 2.0% to \$109,921,000 at September 30, 2010 compared to \$107,771,000 at December 31, 2009. The increase in stockholders' equity reflects net income of \$2,698,000 less cash dividends declared of \$2,047,000, a \$1,394,000 change in unrealized holding gains, net of taxes, on investment in debt securities available-for-sale, \$36,000 amortization of prior service cost for defined benefit plan, and a \$68,000 increase, net of taxes, related to stock option compensation expense.

### ***Liquidity and Capital Resources***

#### **Liquidity Management**

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

Our Company's Asset/Liability Committee (ALCO), primarily made up of senior management, has direct oversight responsibility for our Company's liquidity position and profile. A combination of daily, weekly and monthly reports provided to management detail the following: internal liquidity metrics, composition and level of the liquid asset portfolio, timing differences in short-term cash flow obligations, available pricing and market access to the financial markets for capital and exposure to contingent draws on our Company's liquidity. No material changes in our Company's liquidity or capital resources have occurred since September 30, 2010.

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

| <i>(dollars in thousands)</i>             | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|-----------------------------------|----------------------------------|
| <b>Liquid assets:</b>                     |                                   |                                  |
| Federal funds sold                        | \$ 126                            | \$ 90                            |
| Federal Reserve excess reserves           | 34,680                            | 2,216                            |
| Available for sale investments securities | 165,173                           | 152,927                          |
| <b>Total</b>                              | <b>\$ 199,979</b>                 | <b>\$ 155,233</b>                |

Federal funds sold and resale agreements normally have overnight maturities and are used for general daily liquidity purposes. The fair value of the available for sale investment portfolio was \$165,173,000 at September 30, 2010 and included an unrealized net gain of \$4,604,000. The portfolio includes maturities of approximately \$7,501,000 over the next twelve months, which offer resources to meet either new loan demand or reductions in our Company's deposit base. Our Company pledges portions of its investment securities portfolio to secure public fund deposits, securities sold under agreements to repurchase, trust funds, and borrowing capacity at the Federal Reserve Bank.



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

| <i>(dollars in thousands)</i>                                     | <b>September<br/>30,<br/>2010</b> |
|---|-----------------------------------|
| <b>Investment securities pledged for the purpose of securing:</b> |                                   |
| Federal Reserve Bank borrowings                                   | \$ 3,306                          |
| Repurchase agreements   | 40,589                            |
| Other Deposits  | 97,578                            |
| <b>Total pledged, at fair value</b>                               | <b>\$ 141,473</b>                 |

At September 30, 2010, our Company's unpledged securities in the available for sale portfolio totaled approximately \$23,699,000.

Liquidity is also available from our Company's base of core customer deposits, defined as demand, interest checking, savings, and money market deposit accounts. At September 30, 2010, such deposits totaled \$507,060,000 and represented 53.3% of our Company's total deposits. These core deposits are normally less volatile and are often tied to other products of our Company through long lasting relationships. Time deposits and certificates of deposit of \$100,000 and over totaled \$443,514,000 at September 30, 2010. These accounts are normally considered more volatile and higher costing representing 46.7% of total deposits at September 30, 2010.

| <i>(dollars in thousands)</i> | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|-------------------------------|-----------------------------------|----------------------------------|
| <b>Core deposit base:</b>     |                                   |                                  |
| Non-interest bearing demand   | \$ 143,143                        | \$ 135,018                       |
| Interest checking             | 148,710                           | 139,624                          |
| Savings and money market      | 215,207                           | 214,660                          |
| <b>Total</b>                  | <b>\$ 507,060</b>                 | <b>\$ 489,302</b>                |

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

| <i>(dollars in thousands)</i>                  | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|--|-----------------------------------|----------------------------------|
| <b>Borrowings:</b>                             |                                   |                                  |
| Federal funds purchased                        | \$                                | \$ 4,980                         |
| Securities sold under agreements to repurchase | 31,460                            | 31,665                           |
| FHLB advances                                  | 67,168                            | 79,317                           |
| Subordinated notes                             | 49,486                            | 49,486                           |
| <b>Total</b>                                   | <b>\$ 148,114</b>                 | <b>\$ 165,448</b>                |

Federal funds purchased are overnight borrowings obtained mainly from upstream correspondent banks with which our Company maintains approved credit lines. As of September 30, 2010, under agreements with these unaffiliated banks, the Bank may borrow up to \$35,684,000 in federal funds on an unsecured basis and \$8,905,000 on a secured basis. There were no federal funds purchased outstanding at September 30, 2010. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of our Company's investment portfolio. At September 30, 2010 there was \$31,460,000 in repurchase agreements. Our Company may periodically borrow additional short-term funds from the Federal Reserve Bank through the discount window; although no such borrowings were outstanding at the current quarter end. The Bank is a member of the Federal Home Loan Bank of Des Moines (FHLB). As a member of the FHLB, the Bank has access to credit products of the FHLB. As of September 30, 2010, the Bank had \$67,168,000 in outstanding borrowings with the FHLB. In addition, our Company has \$49,486,000 in outstanding subordinated notes issued to wholly-owned grantor trusts, funded by preferred securities issued by the trusts.

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

| <i>(dollars in thousands)</i> |                   | <b>September 30,<br/>2010</b> |  |                 |
|-------------------------------|-------------------|-------------------------------|--|-----------------|
|                               | <b>FHLB</b>       | <b>Federal Reserve</b>        |  | <b>Other</b>    |
| Collateral value pledged      | \$273,909         | \$ 3,306                      |  | \$ 7,573        |
| Letters of Credit             | (96)              |                               |  |                 |
| Advances outstanding          | (67,168)          |                               |  |                 |
| <b>Total</b>                  | <b>\$ 206,645</b> | <b>\$ 3,306</b>               |  | <b>\$ 7,573</b> |

### **Sources and Uses of Funds**

Cash and cash equivalents were \$52,226,000 at September 30, 2010 compared to \$24,666,000 at December 31, 2009. The \$27,560,000 increase resulted from changes in the various cash flows produced by operating, investing, and financing activities of our Company, as shown in the accompanying consolidated statements of cash flows for the nine months ended September 30, 2010. Cash flow provided from operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of \$11,138,000 during the first nine months of 2010. Investing activities, consisting mainly of purchases, sales and maturities of available for sale securities, and changes in the level of the loan portfolio, provided cash of \$41,801,000. The cash outflow primarily consisted of purchases of \$154,205,000 of investment securities offset by a \$42,321,000 decrease in the loan portfolio, \$143,790,000 in proceeds from maturities, calls, and pay-downs of investment securities, and \$9,185,000 in proceeds from sales of other real estate owned and repossessions. Financing activities used total cash of \$25,380,000, resulting primarily from \$22,149,000 repayments of FHLB advances, \$23,507,000 decrease in time deposits, \$2,296,000 in dividends paid, and \$5,185,000 decrease in federal funds purchased and securities sold under agreements to repurchase, partially offset by a \$17,758,000 increase in interest-bearing transaction accounts. Future short-term liquidity needs arising from daily operations are not expected to vary significantly during 2010.

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

In the normal course of business, our Company enters into certain forms of off-balance sheet transactions, including unfunded loan commitments and letters of credit. These transactions are managed through our Company's various risk management processes. Management considers both on-balance sheet and off-balance sheet transactions in its evaluation of our Company's liquidity. Our Company had \$116,219,000 in unused loan commitments and standby letters of credit as of September 30, 2010. While this commitment level would be difficult to fund given our Company's current liquidity resources, we know that the nature of these commitments are such that the likelihood of such a funding demand is very low.

Our Company is a legal entity, separate and distinct from the Bank, which must provide its own liquidity to meet its operating needs. Our Company's ongoing liquidity needs primarily include funding its operating expenses and paying cash dividends to its common and preferred shareholders. During the nine months ended September 30, 2010 and 2009, our Company paid cash dividends to its common and preferred shareholders totaling \$2,296,000 and \$3,184,000, respectively. A large portion of our Company's liquidity is obtained from the Bank in the form of dividends. For the first nine months ended September 30, 2010, the Bank declared and paid dividends of \$2,700,000. At September 30, 2010 and December 31, 2009, our Company had cash and cash equivalents totaling \$11,640,000

and \$14,738,000 respectively.

**Regulatory Capital**

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

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

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

|   | <b>Actual</b> |              | <b>Minimum<br/>Capital<br/>requirements</b> |              | <b>Well-Capitalized<br/>Capital<br/>Requirements</b> |              |
|---|---------------|--------------|---|--------------|--|--------------|
|   | <b>Amount</b> | <b>Ratio</b> | <b>Amount</b>                               | <b>Ratio</b> | <b>Amount</b>  | <b>Ratio</b> |
| <b>September 30, 2010</b>                           |               |              |   |              |  |              |
| <b>Total capital (to risk-weighted assets):</b>     |               |              |   |              |  |              |
| Company   | \$ 166,430    | 17.47%       | \$ 76,233                                   | 8.00%        |  |              |
| Hawthorn Bank                                       | 137,113       | 14.64        | 74,908                                      | 8.00         | \$ 93,635  | 10.00%       |
| <b>Tier I capital (to risk-weighted assets):</b>    |               |              |   |              |  |              |
| Company   | \$ 142,343    | 14.94        | \$ 38,117                                   | 4.00%        |  |              |
| Hawthorn Bank                                       | 125,387       | 13.39        | 37,454                                      | 4.00         | \$ 56,181  | 6.00%        |
| <b>Tier I capital (to adjusted average assets):</b> |               |              |   |              |  |              |
| Company   | \$ 142,343    | 11.61        | \$ 36,769                                   | 3.00%        |  |              |
| Hawthorn Bank                                       | 125,387       | 10.42        | 36,089                                      | 3.00         | \$ 60,148  | 5.00%        |
| <b>December 31, 2009</b>                            |               |              |   |              |  |              |
| <b>Total capital (to risk-weighted assets):</b>     |               |              |   |              |  |              |
| Company   | \$ 165,969    | 16.49%       | \$ 80,502                                   | 8.00%        |  |              |
| Hawthorn Bank                                       | 134,673       | 13.62        | 79,129                                      | 8.00         | \$ 98,911  | 10.00%       |

**Tier I capital (to risk-weighted assets):**

|               |            |       |           |       |           |       |
|---------------|------------|-------|-----------|-------|-----------|-------|
| Company       | \$ 140,974 | 14.01 | \$ 40,251 | 4.00% |           |       |
| Hawthorn Bank | 122,285    | 12.36 | 39,564    | 4.00  | \$ 59,347 | 6.00% |

**Tier I capital (to adjusted average assets):**

|               |            |       |           |       |           |       |
|---------------|------------|-------|-----------|-------|-----------|-------|
| Company       | \$ 140,974 | 11.35 | \$ 37,254 | 3.00% |           |       |
| Hawthorn Bank | 122,285    | 10.04 | 36,556    | 3.00  | \$ 60,926 | 5.00% |

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

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

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

| <i>(Dollars in thousands)</i>  | <b>Year 1</b>     | <b>Year 2</b>     | <b>Year 3</b>     | <b>Year 4</b>    | <b>Year 5</b>    | <b>Over<br/>5 years<br/>or<br/>no stated<br/>Maturity</b> | <b>Total</b>        |
|--|-------------------|-------------------|-------------------|------------------|------------------|---|---------------------|
| <b>ASSETS</b>  |                   |                   |                   |                  |                  |   |                     |
| Investment securities  | \$ 4,065          | \$ 3,349          | \$ 12,621         | \$ 21,432        | \$ 19,714        | \$ 103,992  | \$ 165,173          |
| Interest-bearing deposits  | 35,209            |                   |                   |                  |                  |   | 35,209              |
| Other restricted investments   | 6,150             |                   |                   |                  |                  |   | 6,150               |
| Federal funds sold and securities purchased under agreements to resell     | 126               |                   |                   |                  |                  |   | 126                 |
| Loans  | 479,656           | 183,927           | 177,327           | 44,055           | 15,188           | 33,303  | 933,456             |
| <b>Total</b>   | <b>\$ 525,206</b> | <b>\$ 187,276</b> | <b>\$ 189,948</b> | <b>\$ 65,487</b> | <b>\$ 34,902</b> | <b>\$ 137,295</b>   | <b>\$ 1,140,114</b> |
| <b>LIABILITIES</b>   |                   |                   |                   |                  |                  |   |                     |
| Savings, Now deposits  | \$                | \$                | \$ 141,499        | \$               | \$               | \$  | \$ 141,499          |
| Rewards checking, Super Now, money market deposits                         | 222,871           |                   |                   |                  |                  |   | 222,871             |
| Time deposits  | 325,525           | 58,962            | 48,382            | 4,359            | 5,833            |   | 443,061             |
| Federal funds purchased and securities sold under agreements to repurchase | 31,460            |                   |                   |                  |                  |   | 31,460              |
| Subordinated notes   | 49,486            |                   |                   |                  |                  |   | 49,486              |
| Other borrowed money   | 48,683            | 293               | 18,190            | 2                |                  |   | 67,168              |
| <b>Total</b>   | <b>\$ 678,025</b> | <b>\$ 59,255</b>  | <b>\$ 208,071</b> | <b>\$ 4,361</b>  | <b>\$ 5,833</b>  | <b>\$</b>   | <b>\$ 955,545</b>   |

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|                          |              |             |             |           |           |            |            |  |
|--------------------------|--------------|-------------|-------------|-----------|-----------|------------|------------|--|
| Interest-sensitivity GAP |              |             |             |           |           |            |            |  |
| Periodic GAP             | \$ (152,819) | \$ 128,021  | \$ (18,123) | \$ 61,126 | \$ 29,069 | \$ 137,295 | \$ 184,569 |  |
| Cumulative GAP           | \$ (152,819) | \$ (24,798) | \$ (42,921) | \$ 18,205 | \$ 47,274 | \$ 184,569 | \$ 184,569 |  |

Ratio of  
interest-earnings assets  
to interest-bearing  
liabilities

|                |      |      |      |       |      |      |      |  |
|----------------|------|------|------|-------|------|------|------|--|
| Periodic GAP   | 0.77 | 3.16 | 0.91 | 15.02 | 5.98 | NM   | 1.19 |  |
| Cumulative GAP | 0.77 | 0.97 | 0.95 | 1.02  | 1.05 | 1.19 | 1.19 |  |



**Item 4. Controls and Procedures**

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

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

**Impact of New Accounting Standards**

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

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

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

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

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

have been evaluated for both issued and revised financial statements. This update became effective upon issuance for our Company and the adoption of this update did not have a material effect on our financial statements

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

PART II OTHER INFORMATION

|   |      |
|---|------|
| Item 1. Legal Proceedings   | None |
| Item 1A. Risk Factors   | None |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | None |
| Item 3. Defaults Upon Senior Securities                             | None |
| Item 4. (Removed and Reserved)                                      | None |
| Item 5. Other Information   | None |

Item 6. Exhibits

Exhibit No. Description

- 3.1 Restated Articles of Incorporation of our Company (filed as Exhibit 3.1 to our Company's current report on Form 8-K on August 9, 2007 and incorporated herein by reference).
- 3.1.1 Certificate of Designations of Fixed Rate Cumulative Perpetual Preferred Stock, Series 2008, dated December 17, 2008 (filed as Exhibit 3.1.1 to our Company's current report on Form 8-K on December 23, 2008 and incorporated herein by reference).
- 3.2 Amended and Restated Bylaws of our Company (filed as Exhibit 3.1 to our Company's current report on Form 8-K on June 8, 2009 and incorporated herein by reference).
- 4.1 Specimen certificate representing shares of our Company's \$1.00 par value common stock (filed as Exhibit 4.1 to our Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1999 (Commission file number 0-23636) and incorporated herein by reference).
- 4.2 Specimen certificate representing shares of our Fixed Rate Cumulative Perpetual Preferred Stock, Series 2008 (filed as Exhibit 4.2 to our Company's current report on Form 8-K on December 23, 2008 and incorporated herein by reference).
- 4.3 Warrant to purchase shares of our Company's \$1.00 par value Common Stock, dated December 19, 2008 (filed as Exhibit 4.3 to our Company's current report on Form 8-K on December 23, 2008 and incorporated herein by reference).
- 31.1 Certificate of the Chief Executive Officer of our Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certificate of the Chief Financial Officer of our Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certificate of the Chief Executive Officer of our Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2

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

**SIGNATURES**

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

**HAWTHORN BANCSHARES, INC.**

Date

/s/ James E. Smith

November 9, 2010 James E. Smith, Chairman of the Board  
and Chief Executive Officer (Principal Executive Officer)

/s/ Richard G. Rose

November 9, 2010 Richard G. Rose, Chief Financial Officer (Principal Financial  
Officer and Principal Accounting Officer)

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INDEX TO EXHIBITS

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| Exhibit No. | Description   | Page No. |
|-------------|---|----------|
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| 32.1        | Certificate of the Chief Executive Officer of our Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   | 48       |
| 32.2        | Certificate of the Chief Financial Officer of our Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   | 49       |

\*\* Incorporated by reference.