

HAWTHORN BANCSHARES, INC.
Form 10-Q
August 14, 2012

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 June 30, 2012

or

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

Commission File Number: 0-23636

HAWTHORN BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

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Missouri **43-1626350**
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)
300 Southwest Longview Boulevard, Lees Summit, Missouri 64081

(Address of principal executive offices) (Zip Code)

Top of Form

(816) 347-8100

(Registrant's telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer Accelerated filer

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

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

As of August 14, 2012, the registrant had 4,839,114 shares of common stock, par value \$1.00 per share, outstanding

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Index to Exhibits located on page 61

Part I - FINANCIAL INFORMATION**Item 1. Financial Statements****HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Balance Sheets (unaudited)**

| | June 30, 2012 | December 31, 2011 |
|--|--------------------------|------------------------------|
| ASSETS | | |
| Loans | \$ 844,104,983 | \$ 842,930,548 |
| Allowances for loan losses | (15,313,584) | (13,809,224) |
| Net loans | 828,791,399 | 829,121,324 |
| Investment in available-for-sale securities, at fair value | 228,269,741 | 213,806,001 |
| Federal funds sold and securities purchased under agreements to resell | 75,000 | 75,000 |
| Cash and due from banks | 40,329,180 | 43,134,530 |
| Premises and equipment - net | 37,350,456 | 37,953,372 |
| Other real estate owned and repossessed assets - net | 21,582,893 | 16,020,023 |
| Accrued interest receivable | 5,280,353 | 5,340,610 |
| Mortgage servicing rights | 2,666,498 | 2,308,377 |
| Intangible assets - net | 336,710 | 542,746 |
| Cash surrender value - life insurance | 2,097,824 | 2,064,452 |
| Other assets | 20,439,155 | 20,794,988 |
| Total assets | \$ 1,187,219,209 | \$ 1,171,161,423 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Deposits: | | |
| Non-interest bearing demand | \$ 169,124,794 | \$ 159,186,859 |
| Savings, interest checking and money market | 402,529,604 | 384,598,688 |
| Time deposits \$100,000 and over | 130,193,612 | 139,504,648 |
| Other time deposits | 282,730,595 | 274,933,958 |
| Total deposits | 984,578,605 | 958,224,153 |
| Federal funds purchased and securities sold under agreements to repurchase | 23,843,510 | 24,516,277 |
| Subordinated notes | 49,486,000 | 49,486,000 |
| Federal Home Loan Bank advances | 28,280,725 | 28,409,989 |
| Accrued interest payable | 1,427,066 | 1,054,202 |
| Other liabilities | 7,461,732 | 6,895,029 |
| Total liabilities | 1,095,077,638 | 1,068,585,650 |
| Stockholders equity: | | |
| Preferred stock, \$0.01 par value per share, 1,000,000 shares authorized; Issued 18,255 shares and 30,255, respectively, \$1,000 per share liquidation value, net of discount | 17,833,215 | 29,317,716 |
| Common stock, \$1 par value Authorized 15,000,000 shares; issued 4,814,852 shares respectively | 4,814,852 | 4,814,852 |

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| | | |
|--|-------------------------|-------------------------|
| Surplus | 31,992,617 | 30,265,992 |
| Retained earnings | 39,570,876 | 40,354,112 |
| Accumulated other comprehensive income, net of tax | 1,446,829 | 1,339,919 |
| Treasury stock; 161,858 shares, at cost | (3,516,818) | (3,516,818) |
| Total stockholders equity | 92,141,571 | 102,575,773 |
| Total liabilities and stockholders equity | \$ 1,187,219,209 | \$ 1,171,161,423 |

See accompanying notes to the unaudited consolidated financial statements.

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

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|--|--|-------------------|--------------------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| INTEREST INCOME | | | | |
| Interest and fees on loans | \$ 10,944,089 | \$ 11,991,200 | \$ 22,186,297 | \$ 24,078,842 |
| Interest on debt securities: | | | | |
| Taxable | 1,084,854 | 1,342,958 | 2,201,283 | 2,497,854 |
| Nontaxable | 227,439 | 254,093 | 462,083 | 529,901 |
| Interest on federal funds sold and securities purchased under agreements to resell | 20 | 25 | 35 | 62 |
| Interest on interest-bearing deposits | 15,627 | 11,695 | 36,900 | 32,288 |
| Dividends on other securities | 24,761 | 40,661 | 56,137 | 84,361 |
| Total interest income | 12,296,790 | 13,640,632 | 24,942,735 | 27,223,308 |
| INTEREST EXPENSE | | | | |
| Interest on deposits: | | | | |
| Savings, interest checking and money market | 328,064 | 447,813 | 653,498 | 931,504 |
| Time deposit accounts \$100,000 and over | 308,900 | 432,649 | 537,566 | 895,821 |
| Other time deposit accounts | 1,004,691 | 1,315,987 | 1,788,696 | 2,738,789 |
| Interest on federal funds purchased and securities sold under agreements to repurchase | 4,755 | 12,628 | 9,444 | 25,983 |
| Interest on subordinated notes | 344,741 | 323,016 | 698,752 | 725,177 |
| Interest on Federal Home Loan Bank advances | 133,669 | 326,008 | 268,048 | 642,967 |
| Total interest expense | 2,124,820 | 2,858,101 | 3,956,004 | 5,960,241 |
| Net interest income | 10,171,970 | 10,782,531 | 20,986,731 | 21,263,067 |
| Provision for loan losses | 1,500,000 | 1,883,334 | 3,200,000 | 3,633,336 |
| Net interest income after provision for loan losses | 8,671,970 | 8,899,197 | 17,786,731 | 17,629,731 |
| NON-INTEREST INCOME | | | | |
| Service charges on deposit accounts | 1,459,564 | 1,419,272 | 2,707,581 | 2,729,763 |
| Trust department income | 224,532 | 228,771 | 436,363 | 423,866 |
| Gain on sale of mortgage loans, net | 475,317 | 215,996 | 993,961 | 462,230 |
| Other | 283,747 | 314,585 | 275,551 | 614,845 |
| Total non-interest income | 2,443,160 | 2,178,624 | 4,413,456 | 4,230,704 |
| NON-INTEREST EXPENSE | | | | |
| Salaries and employee benefits | 4,897,918 | 4,333,620 | 9,704,166 | 9,010,693 |
| Occupancy expense, net | 640,911 | 584,685 | 1,287,552 | 1,223,049 |
| Furniture and equipment expense | 467,535 | 509,104 | 970,658 | 1,015,783 |
| FDIC insurance assessment | 258,730 | 396,266 | 502,581 | 875,013 |
| Legal, examination, and professional fees | 259,193 | 307,105 | 595,915 | 797,609 |
| Advertising and promotion | 218,025 | 269,700 | 461,852 | 501,875 |
| Postage, printing, and supplies | 279,340 | 295,774 | 543,330 | 564,481 |
| Processing expense | 1,011,100 | 812,808 | 1,778,856 | 1,634,885 |
| Other real estate expense | 1,015,079 | 548,436 | 1,596,022 | 1,040,869 |
| Other | 1,049,868 | 950,627 | 2,136,937 | 1,721,592 |

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| | | | | |
|--|------------|------------|--------------|--------------|
| Total non-interest expense | 10,097,699 | 9,008,125 | 19,577,869 | 18,385,849 |
| Income before income taxes | 1,017,431 | 2,069,696 | 2,622,318 | 3,474,586 |
| Income tax expense | 277,400 | 661,202 | 431,552 | 1,112,475 |
| Net income | 740,031 | 1,408,494 | 2,190,766 | 2,362,111 |
| Preferred stock dividends | 295,723 | 382,390 | 665,506 | 752,173 |
| Accretion of discount on preferred stock | 396,380 | 119,118 | 515,499 | 238,237 |
| Net income available to common shareholders | \$ 47,928 | \$ 906,986 | \$ 1,009,761 | \$ 1,371,701 |
| Basic earnings per share | \$ 0.01 | \$ 0.19 | \$ 0.21 | \$ 0.28 |
| Diluted earnings per share | \$ 0.01 | \$ 0.19 | \$ 0.21 | \$ 0.28 |

See accompanying notes to the unaudited consolidated financial statements.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|------------------------------------|--------------|----------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net income | \$ 740,031 | \$ 1,408,494 | \$ 2,190,766 | \$ 2,362,111 |
| Other comprehensive income, net of tax | | | | |
| Unrealized gain on debt securities available-for-sale, net of tax | 133,055 | 1,568,024 | 54,753 | 1,639,760 |
| Defined benefit pension plans: | | | | |
| Amortization of prior service cost included in net periodic pension cost, net of tax | 26,079 | 11,991 | 52,157 | 23,982 |
| Total other comprehensive income | 159,134 | 1,580,015 | 106,910 | 1,663,742 |
| Total comprehensive income | \$ 899,165 | \$ 2,988,509 | \$ 2,297,676 | \$ 4,025,853 |

See accompanying notes to the unaudited consolidated financial statements

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

| | Preferred Stock | Common Stock | Surplus | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total Stock - holders Equity |
|---|----------------------------|-------------------------|----------------------|------------------------------|---|---------------------------|---|
| Balance, January 1, 2011 | \$ 28,841,242 | \$ 4,635,891 | \$ 28,928,545 | \$ 41,857,302 | \$ 742,149 | \$ (3,516,818) | \$ 101,488,311 |
| Net income | | | | 2,362,111 | | | 2,362,111 |
| Other comprehensive income | | | | | 1,663,742 | | 1,663,742 |
| Stock based compensation expense | | | 33,877 | | | | 33,877 |
| Accretion of preferred stock discount | 238,237 | | | (238,237) | | | |
| Stock dividend | | | 1,458,534 | (1,458,534) | | | |
| Cash dividends declared, preferred stock | | | | (756,376) | | | (756,376) |
| Cash dividends declared, common stock | | | | (447,404) | | | (447,404) |
| Balance, June 30, 2011 | \$ 29,079,479 | \$ 4,635,891 | \$ 30,420,956 | \$ 41,318,862 | \$ 2,405,891 | \$ (3,516,818) | \$ 104,344,261 |
| Balance, December 31, 2011 | \$ 29,317,716 | 4,814,852 | 30,265,992 | 40,354,112 | 1,339,919 | (3,516,818) | \$ 102,575,773 |
| Cumulative effect of change in accounting principle | | | | 459,890 | | | 459,890 |
| Balance, January 1, 2012 | \$ 29,317,716 | \$ 4,814,852 | \$ 30,265,992 | \$ 40,814,002 | \$ 1,339,919 | \$ (3,516,818) | \$ 103,035,663 |
| Net income | | | | 2,190,766 | | | 2,190,766 |
| Other comprehensive income | | | | | 106,910 | | 106,910 |

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| | | | | | | | |
|--|----------------------|---------------------|----------------------|----------------------|---------------------|-----------------------|----------------------|
| Stock based compensation expense | | | 19,906 | | | | 19,906 |
| Accretion of preferred stock discount | 515,499 | | | (515,499) | | | |
| Redemption of 12,000 shares of preferred stock | (12,000,000) | | | | | | (12,000,000) |
| Stock dividend | | | 1,706,719 | (1,706,719) | | | |
| Cash dividends declared, preferred stock | | | | | | (746,375) | (746,375) |
| Cash dividends declared, common stock | | | | | (465,299) | | (465,299) |
| Balance, June 30, 2012 | \$ 17,833,215 | \$ 4,814,852 | \$ 31,992,617 | \$ 39,570,876 | \$ 1,446,829 | \$ (3,516,818) | \$ 92,141,571 |

See accompanying notes to the unaudited consolidated financial statements

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

| | Six Months Ended June 30, | |
|--|----------------------------------|---------------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income | \$ 2,190,766 | \$ 2,362,111 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 3,200,000 | 3,633,336 |
| Depreciation expense | 1,002,347 | 963,122 |
| Net amortization of debt securities, premiums, and discounts | 548,876 | 406,130 |
| Amortization of intangible assets | 206,036 | 226,713 |
| Stock based compensation expense | 19,906 | 33,877 |
| Change in fair value of mortgage servicing rights | 711,978 | |
| (Gain) loss on sales and dispositions of premises and equipment | (60,116) | 667 |
| (Gain) loss on sales and dispositions of other real estate owned and repossessions | (75,093) | 258,885 |
| Provision for other real estate owned | 739,412 | 440,805 |
| Decrease in accrued interest receivable | 60,257 | 61,345 |
| Increase in cash surrender value - life insurance | (33,372) | (34,232) |
| Decrease in other assets | 267,680 | 277,522 |
| (Increase) decrease in income tax receivable | (687,408) | 1,112,475 |
| Increase in accrued interest payable | 372,864 | 199,491 |
| Increase in other liabilities | 823,104 | 777,683 |
| Origination of mortgage loans for sale | (38,363,488) | (23,115,786) |
| Proceeds from the sale of mortgage loans | 40,437,045 | 22,336,960 |
| Gain on sale of mortgage loans, net | (993,961) | (462,230) |
| Decrease in net deferred tax asset | 33,346 | 15,332 |
| Other, net | 52,157 | 23,982 |
| Net cash provided by operating activities | 10,452,336 | 9,518,188 |
| Cash flows from investing activities: | | |
| Net (increase) decrease in loans | (13,260,765) | 20,636,247 |
| Purchase of available-for-sale debt securities | (63,135,227) | (83,043,472) |
| Proceeds from maturities of available-for-sale debt securities | 21,927,370 | 19,097,740 |
| Proceeds from calls of available-for-sale debt securities | 26,285,000 | 25,508,000 |
| Proceeds from sales of FHLB stock | 97,000 | 1,077,100 |
| Purchases of premises and equipment | (843,180) | (1,487,479) |
| Proceeds from sales of premises and equipment | 247,464 | 34,249 |
| Proceeds from sales of other real estate owned and repossessions | 3,083,905 | 3,421,481 |
| Net cash used by investing activities | (25,598,433) | (14,756,134) |
| Cash flows from financing activities: | | |
| Net increase in demand deposits | 9,937,935 | 10,390,244 |
| Net increase in interest-bearing transaction accounts | 17,930,916 | 6,971,783 |
| Net decrease in time deposits | (1,514,399) | (1,952,085) |
| Net decrease in federal funds purchased and securities sold under agreements to repurchase | (672,767) | (1,378,786) |
| Repayment of Federal Home Loan Bank advances | (129,264) | (23,329,310) |
| Redemption of 12,000 shares of preferred stock | (12,000,000) | |
| Cash dividends paid - preferred stock | (746,375) | (756,376) |
| Cash dividends paid - common stock | (465,299) | (447,404) |
| Net cash provided (used) by financing activities | 12,340,747 | (10,501,934) |

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| | | |
|---|----------------------|----------------------|
| Net decrease in cash and cash equivalents | (2,805,350) | (15,739,880) |
| Cash and cash equivalents, beginning of year | 43,209,530 | 50,979,800 |
| Cash and cash equivalents, end of year | \$ 40,404,180 | \$ 35,239,920 |

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

| | Six Months Ended June 30, | |
|---|----------------------------------|--------------|
| | 2012 | 2011 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the year for: | | |
| Interest | \$ 3,951,832 | \$ 5,760,750 |
| Income taxes | \$ 1,260,000 | \$ |
| Supplemental schedule of noncash investing and financing activities: | | |
| Other real estate and repossessions acquired in settlement of loans | \$ 9,311,094 | \$ 5,943,302 |
| See accompanying notes to unaudited consolidated financial statements. | | |

HAWTHORN BANCSHARES, INC.

AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

(1) Summary of Significant Accounting Policies

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

The accompanying unaudited consolidated financial statements of our Company have been prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instruction to Form 10-Q, and Rule 10-01 of Regulation S-X. According the unaudited consolidated financial statements do not include all of the information and disclosures required by U.S. GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes included in our Company's Annual Report on Form 10-K for the year ended December 31, 2011.

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

The following represents significant new accounting principles adopted in 2012:

Repurchase Agreements In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*, which deals with the accounting for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The provisions of ASU No. 2011-03 modify the criteria for determining when repurchase agreements would be accounted for as a secured borrowing rather than as a sale. Currently, an entity that maintains effective control over transferred financial assets must account for the transfer as a secured borrowing rather than as a sale. ASU No. 2011-03 removes from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee. The FASB believes that contractual rights and obligations determine effective control and that there does not need to be a requirement to assess the ability to exercise those rights. ASU No. 2011-03 does not change the other existing criteria used in the assessment of effective control. Our Company adopted the provisions of ASU No. 2011-03 prospectively for transactions or modifications of existing transactions that occurred on or after January 1, 2012. As our Company accounted for all of its repurchase agreements as collateralized financing arrangements prior to the adoption of ASU No. 2011-03, the adoption had no impact on the Company's Consolidated Financial Statements.

Fair Value Measurements In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (IFRSs)*, to substantially converge the guidance in U.S. GAAP and IFRS on fair value measurements and disclosures. The provisions of ASU No. 2011-04 result in a consistent definition of fair value and common requirements for the measurement of and disclosure about fair value between U.S. GAAP and IFRS. The changes to U.S. GAAP as a result of ASU No. 2011-04 are as follows: (1) The concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets. ASU No. 2011-04 extends that prohibition to all fair value measurements; (3) An exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity's net exposure to

HAWTHORN BANCSHARES, INC.

AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) Aligns the fair value measurement of instruments classified within an entity's shareholders' equity with the guidance for liabilities; and (5) Disclosure requirements have been enhanced for Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to qualitatively describe the sensitivity of fair value measurements to changes in unobservable inputs and the interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. Our Company adopted the provisions of ASU No. 2011-04 effective January 1, 2012. The fair value measurement provisions of ASU No. 2011-04 had no impact on our Company's Consolidated Financial Statements. See Notes 11 and 12 to the Consolidated Financial Statements for the enhanced disclosures required by ASU No. 2011-04.

Other Comprehensive Income In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*, which revises the manner in which entities present comprehensive income in their financial statements. The provisions of ASU No. 2011-05 allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Under either method, entities are required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. ASU No. 2011-05 also eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity but does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU 2011-05 is effective for periods beginning January 1, 2012 and requires retrospective application. ASU No. 2011-05 was effective for our Company's interim reporting period beginning on or after January 1, 2012, with retrospective application required.

In December 2011, the FASB issued ASU No. 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. The provisions of ASU No. 2011-12 defer indefinitely the requirement for entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. ASU No. 2011-12, which shares the same effective date as ASU No. 2011-05, does not defer the requirement for entities to present components of comprehensive income in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Our Company adopted the provisions of ASU No. 2011-05 and ASU No. 2011-12 which resulted in a new statement of comprehensive income for the interim period ended June 30, 2012. The adoption of ASU No. 2011-05 and ASU No. 2011-12 had no impact on our Company's statements of income and condition.

Servicing Financial Assets On January 1, 2012, our Company opted to measure mortgage servicing rights at fair value as permitted by Accounting Standards Codification (ASC) Topic 860-50 *Accounting for Servicing Financial Assets*. Consistent with ASC 860-50-35-3d, an entity may make an irrevocable decision to subsequently measure a class of servicing assets and servicing liabilities at fair value at the beginning of any fiscal year. The election of this option resulted in the recognition of a cumulative effect of change in accounting principle of \$459,890, net of tax in the amount of \$281,868, which was recorded as an increase to beginning retained earnings, as further described in Note 5 to the consolidated financial statements. As such, effective January 1, 2012, the change in the fair value of mortgage servicing rights are recognized in earnings in the period for which the change occurs. The newly adopted accounting principle is preferable in the circumstances because the fair value measurement method will produce financial information and results more directly aligned with the performance of mortgage servicing rights.

The complete set of significant accounting policies followed in the preparation of the quarterly financial statements are disclosed in the Annual Report on Form 10-K for the year ended December 31, 2011.

HAWTHORN BANCSHARES, INC.**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

(Unaudited)

Stock Dividend On July 1, 2012, our Company paid a special stock dividend of four percent to common shareholders of record at the close of business on June 15, 2012. For all periods presented, share information, including basic and diluted earnings per share, have been adjusted retroactively to reflect this change.

(2) Loans and Allowance for Loan Losses

A summary of loans, by major class within our Company's loan portfolio, at June 30, 2012 and December 31, 2011 are as follows:

| | June 30, 2012 | December 31, 2011 |
|--|--------------------------|------------------------------|
| Commercial, financial, and agricultural | \$ 128,857,496 | \$ 128,555,173 |
| Real estate construction - residential | 19,830,700 | 30,201,198 |
| Real estate construction - commercial | 42,841,472 | 47,696,759 |
| Real estate mortgage - residential | 220,334,153 | 203,454,204 |
| Real estate mortgage - commercial | 404,469,004 | 402,960,327 |
| Installment and other consumer | 27,591,103 | 29,883,986 |
| Unamortized loan origination fees and costs, net | 181,055 | 178,901 |
| Total loans | \$ 844,104,983 | \$ 842,930,548 |

The Bank grants real estate, commercial, installment, and other consumer 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 and other consumer loans consist primarily of the financing of vehicles. At June 30, 2012, loans with a carrying value of \$453,772,000 were pledged to Federal Home Loan Bank as collateral for borrowings and letters of credit.

HAWTHORN BANCSHARES, INC.

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Notes to the Consolidated Financial Statements

(Unaudited)

Allowance for loan losses

The following is a summary of the allowance for loan losses for the three and six months ended June 30, 2012 and 2011:

| | For the Three Months Ended June 30, 2012 | | | | | | | Total |
|-------------------------------------|--|--|---------------------------------------|------------------------------------|-----------------------------------|----------------------------------|--------------|------------------|
| | Commercial, Financial, and Agricultural | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment Loans to Individuals | Unallocated | |
| <i>(in thousands)</i> | | | | | | | | |
| Balance, beginning of period | \$ 2,722 | \$ 727 | \$ 1,410 | \$ 3,563 | \$ 5,976 | \$ 237 | \$ 5 | \$ 14,640 |
| Additions: | | | | | | | | |
| Provision for loan losses | 363 | (54) | 211 | 380 | 525 | 63 | 12 | 1,500 |
| Deductions: | | | | | | | | |
| Loans charged off | 69 | | | 422 | 438 | 132 | | 1,061 |
| Less recoveries on loans | (29) | (36) | (23) | (39) | (44) | (64) | | (235) |
| Net loans charged off | 40 | (36) | (23) | 383 | 394 | 68 | | 826 |
| Balance, end of period | \$ 3,045 | \$ 709 | \$ 1,644 | \$ 3,560 | \$ 6,107 | \$ 232 | \$ 17 | \$ 15,314 |
| | | | | | | | | |
| | For the Six Months Ended June 30, 2012 | | | | | | | Total |
| | Commercial, Financial, and Agricultural | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment Loans to Individuals | Unallocated | |
| <i>(in thousands)</i> | | | | | | | | |
| Balance, beginning of period | \$ 1,804 | \$ 1,188 | \$ 1,562 | \$ 3,251 | \$ 5,734 | \$ 267 | \$ 3 | \$ 13,809 |
| Additions: | | | | | | | | |
| Provision for loan losses | 1,230 | (546) | 59 | 795 | 1,552 | 96 | 14 | 3,200 |
| Deductions: | | | | | | | | |
| Loans charged off | 104 | | | 577 | 1,300 | 271 | | 2,252 |
| Less recoveries on loans | (115) | (67) | (23) | (91) | (121) | (140) | | (557) |
| Net loans charged off | (11) | (67) | (23) | 486 | 1,179 | 131 | | 1,695 |
| Balance, end of period | \$ 3,045 | \$ 709 | \$ 1,644 | \$ 3,560 | \$ 6,107 | \$ 232 | \$ 17 | \$ 15,314 |

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For the Three Months Ended June 30, 2011

| | Commercial, Financial, and Agricultural | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment Loans to Individuals | Unallocated | Total |
|-------------------------------------|---|---|---|---|---|--|-------------|-----------|
| <i>(in thousands)</i> | | | | | | | | |
| Balance, beginning of period | \$ 2,257 | \$ 991 | \$ 1,356 | \$ 3,118 | \$ 3,709 | \$ 223 | \$ 748 | \$ 12,402 |
| Additions: | | | | | | | | |
| Provision for loan losses | 313 | (6) | (276) | 306 | 1,264 | 62 | 220 | 1,883 |
| Deductions: | | | | | | | | |
| Loans charged off | 45 | | | 466 | 160 | 138 | | 809 |
| Less recoveries on loans | (8) | (1) | (250) | (32) | (24) | (72) | | (387) |
| Net loans charged off | 37 | (1) | (250) | 434 | 136 | 66 | | 422 |
| Balance, end of period | \$ 2,533 | \$ 986 | \$ 1,330 | \$ 2,990 | \$ 4,837 | \$ 219 | \$ 968 | \$ 13,863 |

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(Unaudited)

For the Six Months Ended June 30, 2011

| (in thousands) | Real Estate | | | | | | | Unallocated | Total |
|-------------------------------------|---|--|---------------------------------------|------------------------------------|-----------------------------------|----------------------------------|--------|-------------|-------|
| | Commercial, Financial, and Agricultural | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment Loans to Individuals | | | |
| Balance, beginning of period | \$ 2,931 | \$ 2,067 | \$ 1,339 | \$ 3,922 | \$ 3,458 | \$ 231 | \$ 617 | \$ 14,565 | |
| Additions: | | | | | | | | | |
| Provision for loan losses | 406 | 404 | (259) | 533 | 2,091 | 107 | 351 | 3,633 | |
| Deductions: | | | | | | | | | |
| Loans charged off | 873 | 1,547 | | 1,539 | 741 | 247 | | 4,947 | |
| Less recoveries on loans | (69) | (62) | (250) | (74) | (29) | (128) | | (612) | |
| Net loans charged off | 804 | 1,485 | (250) | 1,465 | 712 | 119 | | 4,335 | |
| Balance, end of period | \$ 2,533 | \$ 986 | \$ 1,330 | \$ 2,990 | \$ 4,837 | \$ 219 | \$ 968 | \$ 13,863 | |

The following table provides the balance in the allowance for loan losses at June 30, 2012 and December 31, 2011, and the related loan balance by impairment methodology. Loans evaluated under ASC 310-10-35 include loans on non-accrual status, which are individually evaluated for impairment, troubled debt restructurings, and other impaired loans deemed to have similar risk characteristics. All other loans are collectively evaluated for impairment under ASC 450-20. Although the allowance for loan losses is comprised of specific and general allocations, the entire allowance is available to absorb credit losses.

| | Commercial, Financial, and Agricultural | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment Loans to Individuals | Unallocated | Total |
|---------------------------------------|---|--|---------------------------------------|------------------------------------|-----------------------------------|----------------------------------|-------------|---------------|
| June 30, 2012 | | | | | | | | |
| Allowance for loan losses: | | | | | | | | |
| Individually evaluated for impairment | \$ 1,595,235 | \$ 59,493 | \$ 576,373 | \$ 720,537 | \$ 2,141,184 | \$ | \$ | \$ 5,092,822 |
| Collectively evaluated for impairment | 1,449,561 | 650,002 | 1,067,655 | 2,838,972 | 3,966,186 | 231,593 | 16,793 | 10,220,762 |
| Total | \$ 3,044,796 | \$ 709,495 | \$ 1,644,028 | \$ 3,559,509 | \$ 6,107,370 | \$ 231,593 | \$ 16,793 | \$ 15,313,584 |

Loans outstanding:

| | | | | | | | | |
|----------------------------|--------------|------------|--------------|--------------|---------------|----|----|---------------|
| Individually evaluated for | \$ 6,385,611 | \$ 280,267 | \$ 8,008,355 | \$ 4,979,777 | \$ 25,106,094 | \$ | \$ | \$ 44,760,104 |
|----------------------------|--------------|------------|--------------|--------------|---------------|----|----|---------------|

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| | | | | | | | | |
|---------------------------------------|-----------------------|----------------------|----------------------|-----------------------|-----------------------|----------------------|-----------|-----------------------|
| impairment | | | | | | | | |
| Collectively evaluated for impairment | 122,471,885 | 19,550,433 | 34,833,117 | 215,354,376 | 379,362,910 | 27,772,158 | | 799,344,879 |
| Total | \$ 128,857,496 | \$ 19,830,700 | \$ 42,841,472 | \$ 220,334,153 | \$ 404,469,004 | \$ 27,772,158 | \$ | \$ 844,104,983 |

December 31, 2011

Allowance for loan losses:

| | | | | | | | | |
|---------------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|-------------------|-----------------|----------------------|
| Individually evaluated for impairment | \$ 238,840 | \$ 166,300 | \$ 379,921 | \$ 653,279 | \$ 2,309,226 | \$ | \$ | \$ 3,747,566 |
| Collectively evaluated for impairment | 1,565,342 | 1,021,221 | 1,182,057 | 2,598,203 | 3,424,849 | 266,990 | 2,996 | 10,061,658 |
| Total | \$ 1,804,182 | \$ 1,187,521 | \$ 1,561,978 | \$ 3,251,482 | \$ 5,734,075 | \$ 266,990 | \$ 2,996 | \$ 13,809,224 |

Loans outstanding:

| | | | | | | | | |
|---------------------------------------|-----------------------|----------------------|----------------------|-----------------------|-----------------------|----------------------|-----------|-----------------------|
| Individually evaluated for impairment | \$ 4,427,673 | \$ 1,146,794 | \$ 7,867,059 | \$ 6,569,367 | \$ 33,440,384 | \$ | \$ | \$ 53,451,277 |
| Collectively evaluated for impairment | 124,127,500 | 29,054,404 | 39,829,700 | 196,884,837 | 369,519,943 | 30,062,887 | | 789,479,271 |
| Total | \$ 128,555,173 | \$ 30,201,198 | \$ 47,696,759 | \$ 203,454,204 | \$ 402,960,327 | \$ 30,062,887 | \$ | \$ 842,930,548 |

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

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(Unaudited)

Impaired loans

Impaired loans totaled \$44,918,658 and \$53,619,534 at June 30, 2012 and December 31, 2011 respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings.

The categories of impaired loans at June 30, 2012 and December 31, 2011 are as follows:

| | June 30, 2012 | December 31, 2011 |
|--|----------------------|----------------------|
| Non-accrual loans | \$ 39,529,906 | \$ 46,402,747 |
| Troubled debt restructurings continuing to accrue interest | 5,388,752 | 7,216,787 |
| Total impaired loans | \$ 44,918,658 | \$ 53,619,534 |

The following tables provide additional information about impaired loans at June 30, 2012 and December 31, 2011, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|--|------------------------|--------------------------------|----------------------|
| <u>At June 30, 2012</u> | | | |
| With no related allowance recorded: | | | |
| Commercial, financial and Agricultural | \$ 2,547,912 | \$ 2,648,404 | \$ |
| Real estate - construction residential | 90,794 | 117,000 | |
| Real estate - construction commercial | 1,878,980 | 2,101,438 | |
| Real estate - residential | 1,998,725 | 2,610,655 | |
| Real estate - commercial | 10,122,800 | 14,368,535 | |
| Consumer | 158,554 | 183,507 | |
| Total | \$ 16,797,765 | \$ 22,029,539 | \$ |
| With an allowance recorded: | | | |
| Commercial, financial and Agricultural | \$ 3,837,699 | \$ 3,923,371 | \$ 1,595,235 |
| Real estate - construction residential | 189,473 | 192,303 | 59,493 |
| Real estate - construction commercial | 6,129,375 | 6,226,322 | 576,373 |
| Real estate - residential | 2,981,052 | 3,111,412 | 720,537 |
| Real estate - commercial | 14,983,294 | 15,449,609 | 2,141,184 |
| Total | \$ 28,120,893 | \$ 28,903,017 | \$ 5,092,822 |
| Total impaired loans | \$ 44,918,658 | \$ 50,932,556 | \$ 5,092,822 |

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| | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|--|------------------------|--------------------------------|----------------------|
| At December 31, 2011 | | | |
| With no related allowance recorded: | | | |
| Commercial, financial and Agricultural | \$ 3,546,088 | \$ 3,625,113 | \$ |
| Real estate - construction residential | 584,034 | 788,152 | |
| Real estate - construction commercial | 1,458,346 | 1,755,248 | |
| Real estate - residential | 2,315,344 | 2,653,979 | |
| Real estate - commercial | 15,150,920 | 21,189,966 | |
| Consumer | 168,257 | 177,332 | |
| Total | \$ 23,222,989 | \$ 30,189,790 | \$ |
| With an allowance recorded: | | | |
| Commercial, financial and Agricultural | \$ 881,585 | \$ 904,168 | \$ 238,840 |
| Real estate - construction residential | 562,760 | 562,760 | 166,300 |
| Real estate - construction commercial | 6,408,713 | 6,448,100 | 379,921 |
| Real estate - residential | 4,254,023 | 4,265,660 | 653,279 |
| Real estate - commercial | 18,289,464 | 18,779,725 | 2,309,226 |
| Total | \$ 30,396,545 | \$ 30,960,413 | \$ 3,747,566 |
| Total impaired loans | \$ 53,619,534 | \$ 61,150,203 | \$ 3,747,566 |

The following table presents by class, information related to the average recorded investment and interest income recognized on impaired loans for the three and six months ended June 30, 2012 and 2011:

| | For the Three Months Ended June 30, | | | | For the Six Months Ended June 30, | | | |
|--|--|--|-----------------------------------|--|--------------------------------------|--|-----------------------------------|--|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| | Average Recorded Investment | Interest Recognized For the Period Ended | Average Recorded Investment | Interest Recognized For the Period Ended | Average Recorded Investment | Interest Recognized For the Period Ended | Average Recorded Investment | Interest Recognized For the Period Ended |
| With no related allowance recorded: | | | | | | | | |
| Commercial, financial and Agricultural | \$ 2,597,572 | \$ 21,493 | \$ 2,396,849 | \$ | \$ 2,630,049 | \$ 43,105 | \$ 2,150,452 | \$ 11,074 |
| Real estate - construction residential | 93,283 | | 710,681 | | 254,863 | 6,755 | 1,731,871 | |
| Real estate - construction commercial | 1,571,747 | | 8,256,663 | | 1,505,991 | | 8,251,242 | |
| Real estate - residential | 2,389,527 | 39,892 | 2,801,501 | 7,014 | 3,514,860 | 42,225 | 3,429,353 | 11,698 |
| Real estate - commercial | 12,344,559 | 27,762 | 10,539,605 | | 13,439,332 | 59,404 | 9,977,051 | 18,040 |
| Consumer | 146,281 | 15 | 199,852 | | 153,203 | 326 | 203,899 | 1,349 |

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Total \$ 19,142,969 \$ 89,162 \$ 24,905,151 \$ 7,014 \$ 21,498,298 \$ 151,815 \$ 25,743,868 \$ 42,161

With an allowance recorded:

| | | | | | | | | | |
|--|----------------------|--------------------|----------------------|------------------|----------------------|------------------|----------------------|------------------|--|
| Commercial, financial and | | | | | | | | | |
| Agricultural | \$ 3,841,845 | \$ 7,182 | \$ 1,932,068 | \$ 2,208 | \$ 3,284,473 | \$ 14,402 | \$ 1,818,910 | \$ 4,400 | |
| Real estate - construction residential | 189,473 | | 171,986 | | 241,527 | | 172,315 | | |
| Real estate - construction commercial | 6,146,914 | | 2,362,522 | | 6,186,634 | | 2,067,649 | | |
| Real estate - residential | 2,818,306 | (23,249) | 4,405,202 | 27,140 | 2,666,116 | 6,402 | 3,998,773 | 54,472 | |
| Real estate - commercial | 15,033,149 | | 19,065,164 | 1,648 | 14,496,174 | | 17,998,970 | 3,289 | |
| Total | \$ 28,029,687 | \$ (16,067) | \$ 27,936,942 | \$ 30,996 | \$ 26,874,924 | \$ 20,804 | \$ 26,056,617 | \$ 62,161 | |

Total impaired loans \$ 47,172,656 \$ 73,095 \$ 52,842,093 \$ 38,010 \$ 48,373,222 \$ 172,619 \$ 51,800,485 \$ 104,322

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|-------------------|---------------------------|---------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Contractual interest due on non-accrual loans | \$ 483,281 | \$ 612,472 | \$ 1,109,542 | \$ 1,218,908 |
| Interest income recognized on loans in non-accrual status | (14) | 32,802 | 32 | 32,840 |
| Net reduction in interest income | \$ 483,295 | \$ 579,670 | \$ 1,109,510 | \$ 1,186,068 |

The specific reserve component of our Company's allowance for loan losses at June 30, 2012 and December 31, 2011 was determined by using fair values of the underlying collateral obtained through independent appraisals and internal evaluations, or by discounting the total expected future cash flows. The recorded investment varies from the unpaid principal balance primarily due to partial charge-offs taken resulting from current appraisals received. The amount recognized as interest income on impaired loans continuing to accrue interest, respectively, primarily related to troubled debt restructurings, was \$73,095 and \$38,010, for the three months ended June 30, 2012 and 2011, and \$172,619 and \$104,322 for the six months ended June 30, 2012 and 2011, respectively. The average recorded investment in impaired loans is calculated on a monthly basis during the periods reported.

Delinquent and Non-Accrual Loans

The delinquency status of loans is determined based on the contractual terms of the notes. Borrowers are generally classified as delinquent once payments become 30 days or more past due. The following table provides aging information for our Company's past due and non-accrual loans at June 30, 2012 and December 31, 2011.

| | Current or Less Than 30 Days Past Due | 30 - 89 Days Past Due | 90 Days Past Due And Still Accruing | Non-Accrual | Total |
|---|--|--------------------------|--|----------------------|-----------------------|
| June 30, 2012 | | | | | |
| Commercial, Financial, and Agricultural | \$ 124,367,126 | \$ 461,027 | \$ | \$ 4,029,343 | \$ 128,857,496 |
| Real Estate Construction - Residential | 16,723,616 | 2,826,817 | | 280,267 | 19,830,700 |
| Real Estate Construction - Commercial | 34,432,701 | 400,417 | | 8,008,354 | 42,841,472 |
| Real Estate Mortgage - Residential | 214,108,119 | 1,642,415 | 195,673 | 4,387,946 | 220,334,153 |
| Real Estate Mortgage - Commercial | 380,150,636 | 1,652,926 | | 22,665,442 | 404,469,004 |
| Installment and Other Consumer | 27,233,151 | 379,984 | 469 | 158,554 | 27,772,158 |
| Total | \$ 797,015,349 | \$ 7,363,586 | \$ 196,142 | \$ 39,529,906 | \$ 844,104,983 |
| December 31, 2011 | | | | | |
| Commercial, Financial, and Agricultural | \$ 126,244,521 | \$ 242,672 | \$ | \$ 2,067,980 | \$ 128,555,173 |
| Real Estate Construction - Residential | 29,054,404 | | | 1,146,794 | 30,201,198 |

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| | | | | | |
|---------------------------------------|----------------|--------------|-----------|---------------|----------------|
| Real Estate Construction - Commercial | 39,821,946 | | 7,754 | 7,867,059 | 47,696,759 |
| Real Estate Mortgage - Residential | 195,779,337 | 3,513,373 | 8,566 | 4,152,928 | 203,454,204 |
| Real Estate Mortgage - Commercial | 371,000,415 | 923,704 | 36,479 | 30,999,729 | 402,960,327 |
| Installment and Other Consumer | 29,281,191 | 612,461 | 978 | 168,257 | 30,062,887 |
| Total | \$ 791,181,814 | \$ 5,292,210 | \$ 53,777 | \$ 46,402,747 | \$ 842,930,548 |

Credit Quality

The following table provides information about the credit quality of the loan portfolio using our Company's internal rating system reflecting management's risk assessment. Recent reviews by our Company's chief credit officer identified areas of

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concern that resulted in heightened attention being given to reducing concentrations of credit and, in particular, to strengthening credit quality and administration. Loans are placed on *watch* status when (1) one or more weaknesses which could jeopardize timely liquidation exits; or (2) the margin or liquidity of an asset is sufficiently tenuous that adverse trends could result in a collection problem. Loans classified as *substandard* are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Loans so classified may have a well defined weakness or weaknesses that jeopardize the repayment of the debt. Such loans are characterized by the distinct possibility that our Company may sustain some loss if the deficiencies are not corrected. It is our Company's policy to discontinue the accrual of interest income on loans when management believes that the collection of interest or principal is doubtful. Loans are placed on *non-accrual* status when (1) deterioration in the financial condition of the borrower exists for which payment of full principal and interest is not expected, or (2) payment of principal or interest has been in default for a period of 90 days or more and the asset is not both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectability of such principal; otherwise, such receipts are recorded as interest income on a cash basis.

| | Commercial | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment and other Consumer | Total |
|-----------------------------|---------------|--|---|--|---|--------------------------------------|----------------|
| At June 30, 2012 | | | | | | | |
| Watch | \$ 13,873,941 | \$ 3,757,426 | \$ 7,569,536 | \$ 20,750,281 | \$ 26,084,889 | \$ 529,356 | \$ 72,565,429 |
| Substandard | 5,700,952 | 2,647,446 | 695,529 | 5,701,348 | 13,848,780 | 453,927 | 29,047,982 |
| Non-accrual | 4,029,343 | 280,267 | 8,008,354 | 4,387,946 | 22,665,442 | 158,554 | 39,529,906 |
| Total | \$ 23,604,236 | \$ 6,685,139 | \$ 16,273,419 | \$ 30,839,575 | \$ 62,599,111 | \$ 1,141,837 | \$ 141,143,317 |
| At December 31, 2011 | | | | | | | |
| Watch | \$ 22,206,456 | \$ 9,644,326 | \$ 9,337,768 | \$ 13,231,006 | \$ 24,392,448 | \$ 557,278 | \$ 79,369,282 |
| Substandard | 4,141,582 | 842,063 | 1,189,122 | 4,268,914 | 8,003,868 | 444,003 | 18,889,552 |
| Non-accrual | 2,067,980 | 1,146,794 | 7,867,059 | 4,152,928 | 30,999,729 | 168,257 | 46,402,747 |
| Total | \$ 28,416,018 | \$ 11,633,183 | \$ 18,393,949 | \$ 21,652,848 | \$ 63,396,045 | \$ 1,169,538 | \$ 144,661,581 |

Troubled Debt Restructurings

At June 30, 2012, loans classified as troubled debt restructurings (TDRs) totaled \$28,327,786, of which \$22,939,034 was on non-accrual status and \$5,388,752 was on accrual status. At December 31, 2011, loans classified as TDRs totaled \$32,165,238, of which \$24,948,451 was on non-accrual status and \$7,216,787 was on accrual status. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the underlying collateral less applicable selling costs. Accordingly, specific reserves of \$1,582,679 and \$1,522,422 were allocated to the allowance for loan losses at June 30, 2012 and December 31, 2011, respectively.

The following table summarizes loans that were modified as TDRs during the six months ended June 30, 2012:

The Six Months Ended June 30, 2012
Recorded Investment (1)

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| | Number of Contracts | Pre- Modification | Post- Modification |
|--|---------------------------|----------------------|-----------------------|
| Troubled Debt Restructurings | | | |
| Commercial, financial and agricultural | 1 | \$ 188,036 | \$ 196,061 |
| Real estate construction - commercial | 1 | 43,379 | 43,379 |
| Total | 2 | \$ 231,415 | \$ 239,440 |

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

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According to guidance provided in ASC subtopic 310-40, *Troubled Debt Restructurings by Creditors*, a loan restructuring or modification of terms is a TDR if the creditor, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. Our Company's portfolio of loans classified as TDRs include concessions such as interest rates below the current market rate, deferring principal payments, and extending maturity dates. Once a loan becomes a TDR, it will continue to be reported as a TDR until it is ultimately repaid in full, charged-off, or the collateral for the loan is foreclosed and sold. Our Company considers a loan in TDR status in default when the borrower's payment according to the modified terms is at least 90 days past due or has defaulted due to expiration of the loan's maturity date. During the three months ended June 30, 2012 there were no new loans meeting the TDR criteria. During the six months ended June 30, 2012, two loans meeting the TDR criteria were modified. There were no loans modified as a TDR that defaulted during the three and six months ended June 30, 2012, and within twelve months of their modification date.

(3) Real Estate Acquired in Settlement of Loans

| | June 30, 2012 | December 31, 2011 |
|--|--------------------------|------------------------------|
| Commercial | \$ 17,150 | \$ 17,150 |
| Real estate construction - residential | 191,907 | 306,863 |
| Real estate construction - commercial | 13,453,182 | 13,649,784 |
| Real estate mortgage - residential | 1,737,614 | 2,120,721 |
| Real estate mortgage - commercial | 13,400,266 | 6,623,580 |
| Total | \$ 28,800,119 | \$ 22,718,098 |
| Less valuation allowance for other real estate owned | (7,473,763) | (6,976,985) |
| Total | \$ 21,326,356 | \$ 15,741,113 |

| | |
|---|----------------------|
| Balance at December 31, 2011 | \$ 22,718,098 |
| Additions | 9,166,963 |
| Proceeds from sales | (2,915,596) |
| Charge-offs against the valuation allowance for other real estate owned | (242,634) |
| Net gain on sales | 73,288 |
| Total other real estate owned | \$ 28,800,119 |
| Less valuation allowance for other real estate owned | (7,473,763) |
| Balance at June 30, 2012 | \$ 21,326,356 |

During the six months ended June 30, 2012, net charge-offs against the allowance for loan losses at the time of foreclosure were approximately \$1,670,000.

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Activity in the valuation allowance for other real estate owned in settlement of loans for the three months and six months ended June 30, 2012 and 2011, respectively, is summarized as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------------------|-----------------------------|--------------|---------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Balance, beginning of period | \$ 7,189,793 | \$ 6,319,098 | \$ 6,976,985 | \$ 6,158,433 |
| Provision for other real estate owned | 485,687 | 280,140 | 739,412 | 440,805 |
| Charge-offs | (201,717) | (62,631) | (242,634) | (62,631) |
| Balance, end of period | \$ 7,473,763 | \$ 6,536,607 | \$ 7,473,763 | \$ 6,536,607 |

HAWTHORN BANCSHARES, INC.**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

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

A summary of investment securities by major category, at fair value, consisted of the following at June 30, 2012 and December 31, 2011.

| | June 30, 2012 | December 31, 2011 |
|--|--------------------------|------------------------------|
| U.S. treasury | \$ 2,040,781 | \$ 2,054,102 |
| Government sponsored enterprises | 71,048,653 | 70,313,978 |
| Asset-backed securities | 120,889,297 | 107,328,618 |
| Obligations of states and political subdivisions | 34,291,010 | 34,109,303 |
| Total available for sale securities | \$ 228,269,741 | \$ 213,806,001 |

All of our Company's investment securities are classified as available for sale, as discussed in more detail below. Asset backed securities include agency mortgage-backed securities, which are guaranteed by government sponsored 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 \$4,287,850 and \$4,384,850, as of June 30, 2012 and December 31, 2011 respectively.

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Notes to the Consolidated Financial Statements

(Unaudited)

The amortized cost and fair value of debt securities classified as available-for-sale at June 30, 2012 and December 31, 2011 are as follows:

| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--|-----------------------|------------------------------|-------------------------------|-----------------------|
| June 30, 2012 | | | | |
| U.S. Treasury | \$ 1,999,725 | \$ 41,056 | \$ | \$ 2,040,781 |
| Government sponsored enterprises | 70,281,580 | 768,340 | 1,267 | 71,048,653 |
| Asset-backed securities | 117,286,545 | 3,652,551 | 49,799 | 120,889,297 |
| Obligations of states and political subdivisions | 33,030,619 | 1,279,639 | 19,248 | 34,291,010 |
| Total available for sale securities | \$ 222,598,469 | \$ 5,741,586 | \$ 70,314 | \$ 228,269,741 |
| December 31, 2011 | | | | |
| U.S. Treasury | \$ 1,999,643 | \$ 54,459 | \$ | \$ 2,054,102 |
| Government sponsored enterprises | 69,703,105 | 628,888 | 18,015 | 70,313,978 |
| Asset-backed securities | 103,805,717 | 3,546,712 | 23,811 | 107,328,618 |
| Obligations of states and political subdivisions | 32,716,023 | 1,393,874 | 594 | 34,109,303 |
| Total available for sale securities | \$ 208,224,488 | \$ 5,623,933 | \$ 42,420 | \$ 213,806,001 |

The amortized cost and fair value of debt securities classified as available-for-sale at June 30, 2012, 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 cost | Fair value |
|--|-----------------------|-----------------------|
| Due in one year or less | \$ 1,938,269 | \$ 1,957,432 |
| Due after one year through five years | 80,295,955 | 81,442,563 |
| Due after five years through ten years | 22,326,908 | 23,169,861 |
| Due after ten years | 750,792 | 810,588 |
| | 105,311,924 | 107,380,444 |
| Asset-backed securities | 117,286,545 | 120,889,297 |
| Total | \$ 222,598,469 | \$ 228,269,741 |

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Debt securities with carrying values aggregating approximately \$166,160,000 and \$172,447,000 at June 30, 2012 and December 31, 2011, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

HAWTHORN BANCSHARES, INC.**AND SUBSIDIARIES**

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(Unaudited)

Gross unrealized losses on debt securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2012 and December 31, 2011, were as follows:

| | Less than 12 months | | 12 months or more | | Number of Investment Positions | Total | |
|--|---------------------|----------------------|-------------------|----------------------|--------------------------------------|---------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | Fair Value | Unrealized Losses |
| At June 30, 2012 | | | | | | | |
| Government sponsored enterprises | \$ 2,998,733 | \$ (1,267) | \$ | \$ | 3 | \$ 2,998,733 | (1,267) |
| Asset-backed securities | 14,487,776 | (49,799) | | | 15 | 14,487,776 | \$ (49,799) |
| Obligations of states and political subdivisions | 2,701,689 | (19,029) | 150,290 | (219) | 9 | 2,851,979 | (19,248) |
| | \$ 20,188,198 | \$ (70,095) | \$ 150,290 | \$ (219) | 27 | \$ 20,338,488 | \$ (70,314) |

| | Less than 12 months | | 12 months or more | | Number of Investment Positions | Total | |
|--|---------------------|----------------------|-------------------|----------------------|--------------------------------------|---------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | Fair Value | Unrealized Losses |
| At December 31, 2011 | | | | | | | |
| Government sponsored enterprises | \$ 13,250,239 | \$ (18,015) | \$ | \$ | 13 | \$ 13,250,239 | (18,015) |
| Asset-backed securities | 4,591,075 | (23,811) | | | 5 | 4,591,075 | \$ (23,811) |
| Obligations of states and political subdivisions | 229,089 | (300) | 150,279 | (294) | 2 | 379,368 | (594) |
| | \$ 18,070,403 | \$ (42,126) | \$ 150,279 | \$ (294) | 20 | \$ 18,220,682 | \$ (42,420) |

Our Company's available for sale portfolio consisted of approximately 393 securities at June 30, 2012. One of these securities with an unrealized loss of \$219 had been in the loss position for 12 months or longer. The unrealized loss included in other comprehensive income at June 30, 2012 was caused by interest rate fluctuations. Our Company's available for sale portfolio consisted of approximately 365 securities at December 31, 2011. One of these securities with an unrealized loss of \$294 had been in the loss position for 12 months or longer. The unrealized loss included in other comprehensive income at December 31, 2011 was caused by interest rate fluctuations. Because the decline in fair value is attributable to changes in interest rates and not credit quality these investments were not considered other-than-temporarily impaired at June 30, 2012 and December 31, 2011, respectively.

During the three and six months ended June 30, 2012 and 2011, there were no proceeds from sales of securities and no components of investment securities gains and losses which have been recognized in earnings.

HAWTHORN BANCSHARES, INC.**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)***(5) Intangible Assets***Core Deposit Intangible Asset*

A summary of amortizable intangible assets at June 30, 2012 and December 31, 2011 is as follows:

| | June 30, 2012 | | | December 31, 2011 | | |
|-------------------------|-----------------------|--------------------------|------------|-----------------------|--------------------------|------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Amount | Gross Carrying Amount | Accumulated Amortization | Net Amount |
| Core deposit intangible | \$ 4,795,224 | \$ (4,458,514) | \$ 336,710 | \$ 4,795,224 | \$ (4,252,478) | \$ 542,746 |

Our Company's amortization expense on intangible assets in any given period may be different from the estimated amounts depending upon the acquisition of intangible assets, changes in mortgage interest rates, prepayment rates and other market conditions. The following table shows the estimated future amortization expense based on existing asset balances and the interest rate environment as of June 30, 2012 for the next five years:

| | Core Deposit Intangible Asset |
|------|-------------------------------|
| 2012 | \$ 202,026 |
| 2013 | 134,684 |
| 2014 | |
| 2015 | |
| 2016 | |
| 2017 | |

Changes in the net carrying amount of core deposit intangible assets for the three and six months ended June 30, 2012 and 2011 were as follows:

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|--------------------|---------------|------------------|---------------|
| | June 30, 2012 | June 30, 2011 | June 30, 2012 | June 30, 2011 |
| Balance at beginning of period | \$ 438,721 | \$ 859,483 | \$ 542,746 | \$ 977,509 |
| Additions | | | | |
| Amortization | (102,011) | (108,687) | (206,036) | (226,713) |
| Balance at end of period | \$ 336,710 | \$ 750,796 | \$ 336,710 | \$ 750,796 |

Mortgage Servicing Rights

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On January 1, 2012, our Company opted to measure mortgage servicing rights at fair value as permitted by Accounting Standards Codification (ASC) Topic 860-50 *Accounting for Servicing Financial Assets*. The election of this option resulted in the recognition of a cumulative effect of change in accounting principle of \$459,890, which was recorded as an increase to beginning retained earnings. As such, effective January 1, 2012, changes in the fair value of mortgage servicing rights are recognized in earnings in noninterest income in the period in which the change occurs and no amortization will be recognized on mortgage servicing rights going forward.

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Notes to the Consolidated Financial Statements

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At June 30, 2012 and December 31, 2011, our Company serviced mortgage loans for others totaling \$306,483,761 and \$307,016,245, respectively.

Changes in mortgage servicing rights (MSRs) for the three and six months ended June 30, 2012 and 2011 were as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|--------------|------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Balance at beginning of period | \$ 2,746,606 | \$ 2,327,929 | \$ 2,308,377 | \$ 2,355,990 |
| Re-measurement to fair value upon election to measure servicing rights at fair value | | | 741,758 | |
| Originated mortgage servicing rights | 146,602 | 99,376 | 328,341 | 220,554 |
| Changes in fair value: | | | | |
| Due to change in model inputs and assumptions (1) | 106,045 | | 275,627 | |
| Other changes in fair value (2) | (332,755) | | (987,605) | |
| Amortization | | (155,390) | | (304,629) |
| Balance at end of period | \$ 2,666,498 | \$ 2,271,915 | \$ 2,666,498 | \$ 2,271,915 |

- (1) The change in fair value resulting from changes in valuation inputs or assumptions used in valuation model primarily reflects the change in discount rates and prepayment speed assumptions primarily due to changes in interest rates.
- (2) Other changes in fair value reflect changes due to customer payments and passage of time. This also includes a one time adjustment of a \$538,032 correction of an immaterial prior period error due to changing from the straight-line amortization method to an accelerated amortization method of accounting for amortizing MSRs in prior years. If the aforementioned was corrected as of December 31, 2011, the balance at the beginning of the period would have been \$1,770,345.

The key data and assumptions used in estimating the fair value of our Company's mortgage servicing rights as of June 30, 2012 were as follows:

| | June 30, 2012 |
|--|---------------|
| Weighted-Average Constant Prepayment Rate | 18.13 % |
| Weighted-Average Contractual Life (in years) | 20.00 |
| Weighted-Average Note Rate | 4.49 % |
| Weighted-Average Discount Rate | 8.04 % |

(6) Income Taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 27.3% for the three months ended June 30, 2012 compared to 32.0% for the three months ended June 30, 2011.

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Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 16.5% for the six months ended June 30, 2012 compared to 32.0% for the six months ended June 30, 2011. Excluding an immaterial correction of a prior period error of \$371,000, income taxes as a percentage of earnings before income taxes were 30.6% in comparison to 32.0% for the six months ended June 30, 2012 and 2011, respectively.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not our Company will realize the benefits of these temporary differences at June 30, 2012 and, therefore, has not established a valuation reserve.

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Notes to the Consolidated Financial Statements

*(Unaudited)***(7) Employee Benefit Plans**

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

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|--------------------------------|-------------------------------------|---------------------|-----------------------------------|---------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Payroll taxes | \$ 283,947 | \$ 264,350 | \$ 579,139 | \$ 578,879 |
| Medical plans | 440,645 | 434,470 | 898,148 | 876,789 |
| 401k match | 81,131 | 67,414 | 147,719 | 135,013 |
| Pension plan | 329,953 | 227,592 | 659,907 | 455,185 |
| Profit-sharing | 56,000 | 48,000 | 158,000 | 71,000 |
| Other | 124,484 | 58,405 | 173,298 | 99,968 |
| Total employee benefits | \$ 1,316,160 | \$ 1,100,231 | \$ 2,616,211 | \$ 2,216,834 |

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

Pension

Our Company provides a noncontributory defined benefit pension plan for all full-time employees. An employer is required to recognize the funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. Under our Company's funding policy for the defined benefit pension plan, contributions are made to a trust as necessary to provide for current service and for any unfunded accrued actuarial liabilities over a reasonable period. To the extent that these requirements are fully covered by assets in the trust, a contribution might not be made in a particular year. Our Company made \$746,000 of contributions to the defined benefit plan through August 14, 2012, of which \$238,000 relates to the 2011 plan year and \$508,000 relates to the 2012 plan year. The minimum required contribution for the 2012 plan year is estimated to be \$1,048,000. Our Company has not determined whether it will make any contributions other than the minimum required funding contribution for 2012.

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Notes to the Consolidated Financial Statements

*(Unaudited)***Components of Net Pension Cost and Other Amounts Recognized in Accumulated Other Comprehensive Income**

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

| | Estimated 2012 | Actual 2011 |
|--|---------------------|-------------------|
| Service cost benefits earned during the year | \$ 1,202,624 | \$ 930,691 |
| Interest costs on projected benefit obligations | 667,642 | 603,903 |
| Expected return on plan assets | (721,457) | (705,767) |
| Amortization of prior service cost | 78,628 | 78,628 |
| Amortization of unrecognized net loss | 92,378 | |
| Net periodic pension expense | \$ 1,319,815 | \$ 907,455 |
| Pension expense three months ended June 30, (actual) | \$ 329,953 | \$ 227,592 |
| Pension expense six months ended June 30, (actual) | \$ 659,907 | \$ 455,185 |

(8) Stock Compensation

Our Company's stock option plan provides for the grant of options to purchase up to 526,435 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 options issued in 2008 to acquire 11,133 shares that vested immediately.

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

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Contractual Term (in years) | Aggregate Intrinsic Value (000) |
|----------------------------------|------------------------|--|--|--|
| Outstanding at January 1, 2012 * | 270,634 | \$ 23.51 | | |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | | | | |
| Expired | (49,451) | 18.19 | | |
| Outstanding at June 30, 2012 | 221,183 | \$ 24.70 | 3.5 | \$ |
| Exercisable at June 30, 2012 | 197,928 | \$ 24.97 | 3.3 | \$ |

* Options have been adjusted to reflect a 4% stock dividend paid on July 1, 2012

Total stock-based compensation expense for the three months ended June 30, 2012 and 2011 was \$9,000 and \$12,000, respectively, and for the six months ended June 30, 2012 and 2011 was \$20,000 and \$34,000, respectively. As of June 30, 2012, the total unrecognized compensation expense related to non-vested stock awards was \$78,000 and the related weighted average period over which it is expected to be recognized is approximately three years.

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Notes to the Consolidated Financial Statements

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(9) 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.

Participating 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 287,133 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. On May 9, 2012, our Company redeemed 12,000 shares of preferred stock from the U.S. Department of Treasury by repaying \$12,000,000 of the \$30,255,000 CPP funds along with \$140,000 of accrued and unpaid dividends on the shares redeemed. Related to these shares was an additional \$300,000 of accretion that was recognized at the time of the redemption. The allocated carrying values of the senior preferred stock and common stock warrant at June 30, 2012 were \$17,833,000 and \$2,382,000, respectively.

The 18,255 preferred shares remaining outstanding carry a 5% cumulative dividend through December 2013 and 9% thereafter if not redeemed. Our Company intends to redeem the remaining shares by December 2013. The preferred stock generally does not have any voting rights, subject to an exception in the event our Company fails to pay dividends on the preferred stock for six or more quarterly periods, whether or not consecutive. Under such circumstances, the Treasury will be entitled to vote to elect two directors to the board until all unpaid dividends have been paid or declared and set apart for payment. Our Company is prohibited from paying any dividends with respect to shares of common stock unless all accrued and unpaid dividends are paid in full on the senior preferred stock for all past dividend periods. The Treasury Department may also transfer the senior preferred stock to a third party at any time.

The common stock warrant is exercisable immediately with a ten year term, in whole or in part, at an exercise price of \$15.81 per share. The preferred stock and warrant are classified as stockholders' equity in the consolidated balance sheet and qualify, for regulatory capital purposes, as Tier I capital. For the six months ended June 30, 2012, our Company had declared and paid \$746,000 of dividends and amortized \$515,000 of accretion of the discount on preferred stock.

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Notes to the Consolidated Financial Statements

*(Unaudited)***(10) 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 year. Diluted earnings per share gives effect to all dilutive potential common shares that were outstanding during the year. The calculations of basic and diluted earnings per share are as follows for the periods indicated:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|--|--------------|--------------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Basic earnings per common share: | | | | |
| Net income | \$ 740,031 | \$ 1,408,494 | \$ 2,190,766 | \$ 2,362,111 |
| Less: | | | | |
| Preferred stock dividends | 295,723 | 382,390 | 665,506 | 752,173 |
| Accretion of discount on preferred stock | 396,380 | 119,118 | 515,499 | 238,237 |
| Net income available to common shareholders | \$ 47,928 | \$ 906,986 | \$ 1,009,761 | \$ 1,371,701 |
| Basic earnings per share | \$ 0.01 | \$ 0.19 | \$ 0.21 | \$ 0.28 |
| Diluted earnings per common share: | | | | |
| Net income | \$ 740,031 | \$ 1,408,494 | \$ 2,190,766 | \$ 2,362,111 |
| Less: | | | | |
| Preferred stock dividends | 295,723 | 382,390 | 665,506 | 752,173 |
| Accretion of discount on preferred stock | 396,380 | 119,118 | 515,499 | 238,237 |
| Net income available to common shareholders | \$ 47,928 | \$ 906,986 | \$ 1,009,761 | \$ 1,371,701 |
| Average shares outstanding | 4,839,114 | 4,839,114 | 4,839,114 | 4,839,114 |
| Effect of dilutive stock options | | | | |
| Average shares outstanding including dilutive stock options | 4,839,114 | 4,839,114 | 4,839,114 | 4,839,114 |
| Diluted earnings per share | \$ 0.01 | \$ 0.19 | \$ 0.21 | \$ 0.28 |

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

The following options to purchase shares during the three and six months ended June 30, 2012 and 2011 were not included in the respective computations of diluted earnings per share because the exercise price of the option, when combined with the effect of the unamortized compensation expense, was greater than the average market price of the common shares and were considered anti-dilutive.

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| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|--------------------|----------------|------------------|----------------|
| | June 30, | | June 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Anti-dilutive shares - option shares | 221,183 | 270,835 | 221,183 | 270,835 |
| Anti-dilutive shares - warrant shares | 287,133 | 287,133 | 287,133 | 287,133 |
| Total anti-dilutive shares | 508,316 | 557,968 | 508,316 | 557,968 |

(11) Fair Value Measurements

Our Company uses fair value measurements to record fair value adjustments to certain financial and nonfinancial assets and liabilities. The FASB ASC Topic 820, *Fair Value Measurements and Disclosures*, defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The standard

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applies whenever other standards require (permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, FASB clarified the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. As of June 30, 2012 and December 31, 2011, respectively, there were no transfers into or out of Levels 1-3.

The fair value hierarchy is as follows:

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

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

Level 3 Inputs are unobservable inputs for the asset or liability and significant to the fair value. These may be internally developed using 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.

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 for which our Company is required, in conformity with U.S. GAAP, to carry the asset 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.

Mortgage servicing rights

The fair value of mortgage servicing rights is based on the discounted value of estimated future cash flows utilizing contractual cash flows, servicing rate, constant prepayment rate, servicing cost, and discount rate factors. Accordingly, the fair value is estimated based on a valuation model which calculates the present value of estimated future net servicing income. The model incorporates assumptions that market participants use in estimating future net servicing income, including estimates of prepayment speeds, market discount rates, cost to service, float earnings rates, and other ancillary income, including late fees. The valuation models estimate the present value of estimated future net servicing income. Our Company classifies its servicing rights as Level 3.

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(Unaudited)

| | Fair Value | Fair Value Measurements | | |
|--|-----------------------|--|--|--|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| June 30, 2012: | | | | |
| Assets: | | | | |
| U.S. treasury | \$ 2,040,781 | \$ | \$ 2,040,781 | \$ |
| Government sponsored enterprises | 71,048,653 | | 71,048,653 | |
| Asset-backed securities | 120,889,297 | | 120,889,297 | |
| Obligations of states and political subdivisions | 34,291,010 | | 34,291,010 | |
| Mortgage servicing rights | 2,666,498 | | | 2,666,498 |
| Total | \$ 230,936,239 | \$ | \$ 228,269,741 | \$ 2,666,498 |

| | Fair Value | Fair Value Measurements | | |
|--|-----------------------|--|--|--|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| December 31, 2011: | | | | |
| Assets: | | | | |
| U.S. treasury | \$ 2,054,102 | \$ | \$ 2,054,102 | \$ |
| Government sponsored enterprises | 70,313,978 | | 70,313,978 | |
| Asset-backed securities | 107,328,618 | | 107,328,618 | |
| Obligations of states and political subdivisions | 34,109,303 | | 34,109,303 | |
| Total | \$ 213,806,001 | \$ | \$ 213,806,001 | \$ |

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

**Fair Value Measurements Using
Significant Unobservable Inputs
(Level 3)
Mortgage Servicing Rights**

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| | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2012 |
|---|---|---|
| Balance at beginning of period | \$ 2,746,606 | \$ 2,512,103 |
| Total gains or losses (realized/unrealized): | | |
| Included in earnings | (80,108) | 154,395 |
| Included in other comprehensive income | | |
| | | |
| Balance at end of period | \$ 2,666,498 | \$ 2,666,498 |
| | | |
| Total gains or losses for the three and six months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2012 | \$ 106,045 | \$ 275,627 |

HAWTHORN BANCSHARES, INC.

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Notes to the Consolidated Financial Statements

(Unaudited)

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 net carrying value of impaired loans is generally based on fair values of the underlying collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. Once the fair value of the collateral has been determined and any impairment amount calculated, a specific reserve allocation is made. Because many of these inputs are not observable, the measurements are classified as Level 3. As of June 30, 2012, our Company identified \$28.1 million in impaired loans that had specific allowances for losses aggregating \$5.1 million. Related to these loans, there was \$1.6 million in charge-offs recorded during the six months ended June 30, 2012.

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 loan balance 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.

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| Description | Fair Value Measurements Using | | | | Total Gains (Losses)* |
|--|--------------------------------|--|--|--|--------------------------|
| | Fair Value June 30, 2012 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Impaired loans: | | | | | |
| Commercial, financial, & agricultural | \$ 2,242,464 | \$ | \$ | \$ 2,242,464 | \$ (48,634) |
| Real estate construction - residential | 129,980 | | | 129,980 | |
| Real estate construction - commercial | 5,553,002 | | | 5,553,002 | |
| Real estate mortgage - residential | 2,260,515 | | | 2,260,515 | (545,454) |
| Real estate mortgage - commercial | 12,842,110 | | | 12,842,110 | (1,022,597) |
| Total | \$ 23,028,071 | \$ | \$ | \$ 23,028,071 | \$ (1,616,685) |
| Other real estate owned and repossessed assets | \$ 21,582,893 | \$ | \$ | \$ 21,582,893 | \$ (408,527) |

| Description | Fair Value Measurements Using | | | | Total Gains (Losses)* |
|--|------------------------------------|--|--|--|--------------------------|
| | Fair Value December 31, 2011 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Impaired loans: | | | | | |
| Commercial, financial, & agricultural | \$ 642,745 | \$ | \$ | \$ 642,745 | \$ (2,135,996) |
| Real estate construction - residential | 396,460 | | | 396,460 | (1,556,738) |
| Real estate construction - commercial | 6,028,792 | | | 6,028,792 | (279,088) |
| Real estate mortgage - residential | 3,600,744 | | | 3,600,744 | (1,509,328) |
| Real estate mortgage - commercial | 15,980,238 | | | 15,980,238 | (5,841,988) |
| Total | \$ 26,648,979 | \$ | \$ | \$ 26,648,979 | \$ (11,323,138) |
| Other real estate owned and repossessed assets | \$ 16,020,023 | \$ | \$ | \$ 16,020,023 | \$ (2,111,929) |

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

(12) Fair Value of Financial Instruments

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

Loans

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

Investment Securities

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

HAWTHORN BANCSHARES, INC.

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Notes to the Consolidated Financial Statements

(Unaudited)

Federal Home Loan Bank (FHLB) Stock

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

Federal Funds Sold, Cash, and Due from Banks

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

Mortgage Servicing Rights

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

Cash surrender value life insurance

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

Accrued Interest Receivable and Payable

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

Deposits

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

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.

Subordinated Notes and Other Borrowings

The fair value of subordinated notes and other 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.

HAWTHORN BANCSHARES, INC.

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Notes to the Consolidated Financial Statements

(Unaudited)

A summary of the carrying amounts and fair values of our Company's financial instruments at June 30, 2012 and December 31, 2011 is as follows:

| | June 30, 2012 | | June 30, 2012 Fair Value Measurements | | | December 31, 2011 | |
|--|--------------------|------------------|--|--|---|--------------------|------------------|
| | Carrying amount | Fair value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Net Significant Unobservable Inputs (Level 3) | Carrying amount | Fair value |
| Assets: | | | | | | | |
| Loans | \$ 828,791,399 | \$ 825,932,000 | \$ | \$ | \$ 825,932,000 | \$ 829,121,324 | \$ 830,077,000 |
| Investment securities | 228,269,741 | 228,269,741 | | 228,269,741 | | 213,806,001 | 213,806,001 |
| FHLB stock | 2,641,100 | 2,641,100 | | 2,641,100 | | 2,738,100 | 2,738,100 |
| Federal fund sold and securities purchased under agreements to resell | 75,000 | 75,000 | 75,000 | | | 75,000 | 75,000 |
| Cash and due from banks | 40,329,180 | 40,329,180 | 40,329,180 | | | 43,134,530 | 43,134,530 |
| Mortgage servicing rights | 2,666,498 | 2,666,498 | | | 2,666,498 | 2,308,377 | 2,512,103 |
| Cash surrender value - life insurance | 2,097,824 | 2,097,824 | | 2,097,824 | | 2,064,452 | 2,064,452 |
| Accrued interest receivable | 5,280,353 | 5,280,353 | 5,280,353 | | | 5,340,610 | 5,340,610 |
| | \$ 1,110,151,095 | \$ 1,107,291,696 | \$ 45,684,533 | \$ 233,008,665 | \$ 828,598,498 | \$ 1,098,588,394 | \$ 1,099,747,796 |
| Liabilities: | | | | | | | |
| Deposits: | | | | | | | |
| Demand | \$ 169,124,794 | \$ 169,124,794 | \$ | \$ 169,124,794 | \$ | \$ 159,186,859 | \$ 159,186,859 |
| NOW | 185,378,393 | 185,378,393 | | 185,378,393 | | 169,451,594 | 169,451,594 |
| Savings | 67,514,234 | 67,514,234 | | 67,514,234 | | 62,075,470 | 62,075,470 |
| Money market | 149,636,977 | 149,636,977 | | 149,636,977 | | 153,071,624 | 153,071,624 |
| Time | 412,924,207 | 419,049,000 | | 419,049,000 | | 414,438,606 | 421,687,000 |
| Federal funds purchased and securities sold under agreements to repurchase | 23,843,510 | 23,843,510 | | 23,843,510 | | 24,516,277 | 24,516,277 |

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| | | | | | | | |
|---------------------------------|------------------|------------------|--------------|------------------|----|------------------|------------------|
| Subordinated notes | 49,486,000 | 21,328,000 | | 21,328,000 | | 49,486,000 | 22,082,000 |
| Federal Home Loan Bank advances | 28,280,725 | 29,134,000 | | 29,134,000 | | 28,409,989 | 29,525,000 |
| Accrued interest payable | 1,427,066 | 1,427,066 | 1,427,066 | | | 1,054,202 | 1,054,202 |
| | \$ 1,087,615,906 | \$ 1,066,435,974 | \$ 1,427,066 | \$ 1,065,008,908 | \$ | \$ 1,061,690,621 | \$ 1,042,650,026 |

Off-Balance Sheet Financial Instruments

The fair value of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the likelihood of the counterparties drawing on such financial instruments, and the present creditworthiness of such counterparties. Our Company believes such commitments have been made on terms, which are competitive in the markets in which it operates.

Limitations

The fair value estimates provided are made at a point in time based on market information and information about the financial instruments. Because no market exists for a portion of our Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the fair value estimates.

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Notes to the Consolidated Financial Statements

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(13) Pending Litigation

Our Company and its subsidiaries are defendants in various legal actions incidental to our Company's past and current business activities. At June 30, 2012 and December 31, 2011, our Company's consolidated balance sheets included liabilities for these legal actions of \$200,000, respectively. Based on our Company's analysis, and considering the inherent uncertainties associated with litigation, management does not believe that it is reasonably possible that these legal actions will materially adversely affect our Company's consolidated financial statements or results of operations in the near term.

On November 18, 2010, a suit was filed against our Company and its subsidiary, the Bank, in the Circuit Court of Jackson County for the Eastern Division of Missouri state court by a customer alleging that the fees associated with the Bank's automated overdraft program in connection with its debit card and ATM cards constitute unlawful interest in violation of Missouri's usury laws. The suit seeks class-action status for Bank customers who have paid overdraft fees on their checking accounts. The suit seeks forfeiture and refund of twice the amount of improper overdraft fees assessed and collected. The court has denied the Bank's motion to dismiss the suit. At this early stage of the litigation, it is not possible for management of the Bank to determine the probability of a material adverse outcome or reasonably estimate the amount of any potential loss.

On December 17, 2009, a suit was filed against the Bank in Circuit Court of Jackson County for the Eastern Division of Missouri state court by a customer alleging that the Bank had not followed through on its commitment to fund a loan request. A jury found in favor of the customer and awarded \$630,000 in damages to the plaintiffs, including \$200,000 in punitive damages. After hearing post-judgment motions, the trial court struck the punitive damage award and entered an amended judgment for a total of \$510,000 against the Bank. As of June 30, 2012, our Company carried a liability of \$200,000 with respect to this matter. Our Company is in the appeals process and the probable outcome is presently not determinable.

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 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, 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 under the Act are expected to primarily impact financial institutions with assets greater than \$10 billion, our Company expects these new regulations could reduce our revenues and increase our expenses in the future. Management is currently assessing the impact of the Act and of the regulations anticipated to be promulgated under the Act

We have described under the caption *Risk Factors* in our Annual Report on Form 10-K for the year ended December 31, 2011, 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

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Through the branch network of its subsidiary bank, our Company, Hawthorn Bancshares, Inc., 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.

Much of our Company's business is commercial, commercial real estate development, and mortgage lending. Our Company has experienced soft loan demand in the communities within which we operate during the current economic slowdown. Our Company's income from mortgage brokerage activities is directly dependent on mortgage rates and the level of home purchases and refinancings.

The successes of our Company's growth strategy depends primarily on the ability of our banking subsidiary to generate an increasing level of loans and deposits at acceptable risk levels and on acceptable terms without significant increases in non-interest expenses relative to revenues generated. Our Company's financial performance also depends, in part, on our ability to manage various portfolios and to successfully introduce additional financial products and services by expanding new and existing customer relationships, utilizing improved technology, and enhancing customer satisfaction. Furthermore, the success of our Company's growth strategy depends on our ability to maintain sufficient regulatory capital levels during periods in which general economic conditions are unfavorable and despite economic conditions being beyond our control.

Our subsidiary Bank is a full service bank conducting a general banking business, offering its customers checking and savings accounts, debit cards, certificates of deposit, safety deposit boxes and a wide range of lending services, including commercial and industrial loans, residential real estate loans, single payment personal loans, installment loans and credit card accounts. In addition, our Bank provides trust services.

The deposit accounts of our Bank are insured by the Federal Deposit Insurance Corporation or FDIC to the extent provided by law. The operations of our Bank are supervised and regulated by the FDIC and the Missouri Division of Finance. Periodic examinations of our Bank are conducted by representatives of the FDIC and the Missouri Division of Finance. Such regulations, supervision and examinations are principally for the benefit of depositors, rather than for the benefit of shareholders. Hawthorn Bancshares is subject to supervision and examination by the Federal Reserve Board.

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. Further discussion of the methodology used in establishing the allowance and the impact of any associated risks related to these policies on our business operations is provided in Note 1 to our Company's consolidated financial statements and is also discussed in the *Lending and Credit Management* section below. Many of the loans are deemed collateral dependent for purposes of the measurement of the impairment loss, thus the fair value of the underlying collateral and sensitivity of such fair values due to changing market conditions, supply and demand, condition of the collateral and other factors can be volatile over periods of time. Such volatility can have an impact on the financial performance of our Company.

Valuation of Investment Securities

At the time of purchase, debt securities are classified into one of two categories: available-for-sale or held-to-maturity. Held-to-maturity securities are those securities which our Company has the positive intent and ability to hold until maturity. All debt securities not classified as held-to-maturity are classified as available-for-sale. Our Company's securities are classified as available-for-sale and are carried at fair value. Changes in fair value, excluding certain losses

associated with other-than-temporary impairment, are reported in other comprehensive income, net of taxes, a component of stockholders' equity. Securities are periodically evaluated for other-than-temporary impairment in accordance with guidance provided in the FASB ASC Topic 320, *Investments - Debt and Equity Securities*. For those securities with other-than-temporary impairment, the entire loss in fair value is required to be recognized in current earnings if our Company intends to sell the securities or believes it more likely than not that it will be required to sell the security before the anticipated recovery. If neither condition is met, but our Company does not expect to recover the amortized cost basis, our Company determines whether a credit loss has occurred, which is then recognized in current earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

Premiums and discounts are amortized using the interest method over the lives of the respective securities, with consideration of historical and estimated prepayment rates for mortgage-backed securities, as an adjustment to yield. Dividend and interest income are recognized when earned. Realized gains and losses for securities classified as available-for-sale are included in earnings based on the specific identification method for determining the cost of securities sold.

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 forwards 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 we expect to realize the deferred tax asset. 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 penalties and interest related to income taxes in income tax expense.

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 initially recorded as held for sale at the lower of the loan balance or fair value of the collateral less estimated selling costs. Any adjustment is recorded as a charge-off against the allowance for loan losses. Our Company relies on external appraisals and assessment of property values by internal staff. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgment based on experience and expertise of internal specialists. Subsequent to foreclosure, valuations are updated periodically, and the assets may be written down to reflect a new cost basis. The write-downs are recorded as other real estate expense. Our Company establishes a valuation allowance related to other real estate owned on an asset-by-asset basis. The valuation allowance is created during the holding period when the fair value less cost to sell is lower than the cost of a parcel of other real estate.

SELECTED CONSOLIDATED FINANCIAL DATA

The following table presents selected consolidated financial information for our Company as of and for each of the three and six months ended June 30, 2012 and 2011, respectively. 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 | | Six Months | |
|---|-------------------|---------|-------------------|---------|
| | Ended June 30, | | Ended June 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Per Share Data | | | | |
| Basic earnings per common share | \$ 0.01 | \$ 0.19 | \$ 0.21 | \$ 0.28 |
| Diluted earnings per common share | 0.01 | 0.19 | 0.21 | 0.28 |
| Dividends paid on preferred stock | 368 | 378 | 746 | 756 |
| Amortization of discount on preferred stock | 396 | 119 | 515 | 238 |
| Dividends paid on common stock | 232 | 223 | 465 | 447 |
| Book value per common share | | | 15.36 | 15.55 |
| Market price per common share | | | 9.23 | 7.37 |
| Selected Ratios | | | | |
| <i>(Based on average balance sheets)</i> | | | | |
| Return on average total assets | 0.25% | 0.47% | 0.37% | 0.40% |
| Return on average common stockholders' equity | 0.26% | 4.93% | 2.73% | 3.75% |
| Average common stockholders' equity to average total assets | 6.30% | 6.17% | 6.26% | 6.14% |
| <i>(Based on end-of-period data)</i> | | | | |
| Efficiency ratio (1) | 80.05% | 69.51% | 77.08% | 72.12% |
| Period-end common stockholders' equity to period-end assets | | | 6.26% | 6.30% |
| Period-end stockholders' equity to period-end assets | | | 7.76% | 8.73% |
| Total risk-based capital ratio | | | 16.90% | 17.54% |
| Tier 1 risk-based capital ratio | | | 13.63% | 14.76% |
| Leverage ratio | | | 10.17% | 11.31% |

(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 ANALYSIS

Our Company has prepared all of the consolidated financial information in this report in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). In preparing the consolidated financial statements in accordance with U.S. GAAP, our Company makes estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurances that actual results will not differ from those estimates.

| <i>(Dollars in thousands)</i> | Three months ended | | | | Six months ended | | | |
|--|---------------------------|-----------------|------------------|-----------------|-------------------------|-----------------|------------------|-----------------|
| | 2012 | 2011 | \$ Change | % Change | 2012 | 2011 | \$ Change | % Change |
| Net interest income | \$ 10,172 | \$ 10,782 | \$ (610) | (5.7)% | \$ 20,987 | \$ 21,263 | \$ (276) | (1.3)% |
| Provision for loan losses | 1,500 | 1,883 | (383) | (20.3) | 3,200 | 3,633 | (433) | (11.9) |
| Noninterest income | 2,443 | 2,178 | 265 | 12.2 | 4,413 | 4,231 | 182 | 4.3 |
| Noninterest expense | 10,098 | 9,008 | 1,090 | 12.1 | 19,578 | 18,386 | 1,192 | 6.5 |
| Income before income taxes | 1,017 | 2,069 | (1,052) | (50.8) | 2,622 | 3,475 | (853) | (24.5) |
| Income tax expense | 277 | 661 | (384) | (58.1) | 431 | 1,113 | (682) | (61.3) |
| Net income | \$ 740 | \$ 1,408 | \$ (668) | (47.4)% | \$ 2,191 | \$ 2,362 | \$ (171) | (7.2)% |
| Less: preferred dividends and accretion of discount | 296 | 382 | (86) | (22.5) | 666 | 752 | (86) | (11.4) |
| | 396 | 119 | 277 | 232.8 | 515 | 238 | 277 | 116.4 |
| Net income available to common shareholders | \$ 48 | \$ 907 | \$ (859) | (94.7)% | \$ 1,010 | \$ 1,372 | \$ (362) | (26.4)% |

Our Company's consolidated net income of \$740,000 for the three months ended June 30, 2012 decreased \$668,000 compared to consolidated net income of \$1,408,000 for the three months ended June 30, 2011. Our Company recorded preferred stock dividends and accretion on preferred stock of \$692,000 for the three months ended June 30, 2012, resulting in \$48,000 of net income available for common shareholders compared to net income available for common shareholders of \$907,000 for the three months ended June 30, 2011. Diluted earnings per share decreased from \$0.19 per common share for the three months ended June 30, 2011 to \$0.01 per common share for the three months ended June 30, 2012. The provision for loan losses decreased \$383,000, or 20.3%, from June 30, 2011 to June 30, 2012. On May 9, 2012, our Company redeemed 12,000 of the 30,255 shares of preferred stock issued under the U.S. Treasury's CPP program. Related to these shares was an additional \$300,000 of accretion that was recognized at the time of the redemption. Our Company's net interest income, on a tax equivalent basis, decreased \$626,000, or 5.0%, to \$10,309,000 for the three months ended June 30, 2012 compared to \$10,935,000 for the three months ended June 30, 2011. For the three months ended June 30, 2012, the return on average assets was 0.25%, the return on average common stockholders equity was 0.26%, and the efficiency ratio was 80.0%. Net interest margin decreased from 3.95% to 3.77% from June 30, 2011 to 2012, respectively.

Our Company's consolidated net income of \$2,191,000 for the six months ended June 30, 2012 decreased \$171,000 compared to consolidated net income of \$2,362,000 for the six months ended June 30, 2011. Our Company recorded preferred stock dividends and accretion on preferred stock of \$1,181,000 for the six months ended June 30, 2012, resulting in \$1,010,000 of net income available for common shareholders compared to net income available for common shareholders of \$1,372,000 for the six months ended June 30, 2011. Diluted earnings per share decreased from \$0.28 per common share for the six months ended June 30, 2011 to \$0.21 per common share for the six months ended June 30, 2012. The provision for loan losses decreased \$433,000, or 11.9%, from June 30, 2011 to June 30, 2012. Our Company's net interest income, on a tax equivalent basis, decreased \$309,000, or 1.43%, to \$21,266,000 for the six months ended June 30, 2012 compared to \$21,575,000 for the six months ended June 30, 2011. The \$681,000 decrease in income tax expense includes a \$371,000 immaterial correction of a prior period error. For the six months ended June 30, 2012, the return on average assets was 0.37%, the return on average common stockholders equity was 2.73%, and the efficiency ratio was 77.1%. Net interest margin decreased from 3.90% to 3.87% from June 30, 2011 to 2012, respectively.

Total assets at June 30, 2012 were \$1,187,219,000, compared to \$1,171,161,000 at December 31, 2011, an increase of \$16,058,000, or 1.4%. On July 1, 2012, our Company distributed a four percent stock dividend for the third consecutive year to common shareholders of record at the close of business June 15, 2012. For all periods presented, share information, including basic and diluted earnings per share, have been adjusted retroactively to reflect the stock dividend.

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 and six month periods ended June 30, 2012 and June 30, 2011, respectively.

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| | The Three Months Ended June 30, | | | | | |
|--|---------------------------------|-----------------------------------|----------------------------|---------------------|-----------------------------------|----------------------------|
| | 2012 | | | 2011 | | |
| | Average Balance | Interest Income/ Expense(1) | Rate Earned/ Paid(1) | Average Balance | Interest Income/ Expense(1) | Rate Earned/ Paid(1) |
| ASSETS | | | | | | |
| Loans: (2) (4) | | | | | | |
| Commercial | \$ 128,451 | \$ 1,638 | 5.11% | \$ 127,749 | \$ 1,754 | 5.51% |
| Real estate construction - residential | 18,753 | 243 | 5.20 | 29,118 | 436 | 6.01 |
| Real estate construction - commercial | 42,257 | 437 | 4.15 | 51,659 | 562 | 4.36 |
| Real estate mortgage - residential | 219,785 | 3,062 | 5.59 | 202,758 | 2,898 | 5.73 |
| Real estate mortgage - commercial | 409,017 | 5,133 | 5.03 | 430,919 | 5,842 | 5.44 |
| Consumer | 28,759 | 457 | 6.37 | 30,004 | 527 | 7.05 |
| Total Loans | \$ 847,022 | \$ 10,970 | 5.19% | \$ 872,207 | \$ 12,019 | 5.53% |
| Investment in securities: (3) | | | | | | |
| U.S. treasury | \$ 2,046 | \$ 8 | 1.57% | \$ 1,869 | \$ 8 | 1.72% |
| Government sponsored enterprises | 75,886 | 268 | 1.42 | 68,494 | 330 | 1.93 |
| Asset backed securities | 117,440 | 798 | 2.73 | 116,684 | 994 | 3.42 |
| State and municipal | 34,172 | 349 | 4.10 | 31,266 | 389 | 4.99 |
| Total Investment securities | \$ 229,544 | \$ 1,423 | 2.49% | \$ 218,313 | \$ 1,721 | 3.16% |
| Restricted Investments | 4,303 | 25 | 2.33 | 5,267 | 41 | 3.12 |
| Federal funds sold | 73 | | | 165 | | |
| Interest bearing deposits in other financial institutions | 17,104 | 16 | 0.38 | 13,522 | 12 | 0.36 |
| Total interest earning assets | \$ 1,098,046 | \$ 12,434 | 4.54% | \$ 1,109,474 | \$ 13,793 | 4.99% |
| All other assets | 101,753 | | | 99,251 | | |
| Allowance for loan losses | (14,758) | | | (12,773) | | |
| Total assets | \$ 1,185,041 | | | \$ 1,195,952 | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | |
| NOW accounts | \$ 188,236 | \$ 204 | 0.43% | \$ 184,459 | \$ 258 | 0.56% |
| Savings | 66,894 | 18 | 0.11 | 60,502 | 35 | 0.23 |
| Money market | 149,723 | 107 | 0.29 | 151,436 | 154 | 0.41 |
| Time deposits of \$100,000 and over | 129,612 | 308 | 0.95 | 128,363 | 433 | 1.35 |
| Other time deposits | 281,454 | 1,004 | 1.43 | 295,426 | 1,316 | 1.79 |
| Total time deposits | \$ 815,919 | \$ 1,641 | 0.81% | \$ 820,186 | \$ 2,196 | 1.07% |
| Federal funds purchased and securities sold under agreements to repurchase | 23,104 | 5 | 0.09 | 27,574 | 13 | 0.19 |
| Subordinated notes | 49,486 | 345 | 2.80 | 49,486 | 323 | 2.62 |
| Federal Home Loan Advances | 28,323 | 134 | 1.90 | 47,984 | 326 | 2.73 |
| Total borrowings | \$ 100,913 | \$ 484 | 1.92% | \$ 125,044 | \$ 662 | 2.12% |
| Total interest bearing liabilities | \$ 916,832 | \$ 2,125 | 0.93% | \$ 945,230 | \$ 2,858 | 1.21% |
| Demand deposits | 162,681 | | | 142,363 | | |
| Other liabilities | 8,153 | | | 5,509 | | |
| Total liabilities | 1,087,666 | | | 1,093,102 | | |

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| | | |
|---|---------------------|---------------------|
| Stockholders' equity | 97,375 | 102,850 |
| Total liabilities and stockholders' equity | \$ 1,185,041 | \$ 1,195,952 |
| Net interest income (FTE) | \$ 10,309 | \$ 10,935 |
| Net interest spread | 3.61% | 3.78% |
| Net interest margin | 3.77% | 3.95% |

- (1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 34%, net of nondeductible interest expense. Such adjustments totaled \$137,000 and \$152,000 for the three months ended June 30, 2012 and 2011, 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.

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| (Dollars In thousands) | The Six Months Ended June 30, | | | | | |
|--|-------------------------------|-----------------------------------|----------------------------|---------------------|-----------------------------------|----------------------------|
| | 2012 | | | 2011 | | |
| | Average Balance | Interest Income/ Expense(1) | Rate Earned/ Paid(1) | Average Balance | Interest Income/ Expense(1) | Rate Earned/ Paid(1) |
| ASSETS | | | | | | |
| Loans: (2) (4) | | | | | | |
| Commercial | \$ 128,413 | \$ 3,293 | 5.14% | \$ 128,364 | \$ 3,491 | 5.48% |
| Real estate construction - residential | 21,043 | 703 | 6.70 | 30,709 | 853 | 5.60 |
| Real estate construction - commercial | 42,598 | 919 | 4.33 | 53,463 | 1,166 | 4.40 |
| Real estate mortgage - residential | 216,265 | 5,998 | 5.56 | 204,044 | 5,813 | 5.75 |
| Real estate mortgage - commercial | 406,432 | 10,398 | 5.13 | 431,838 | 11,950 | 5.58 |
| Consumer | 28,532 | 927 | 6.52 | 30,383 | 1,062 | 7.05 |
| Total Loans | \$ 843,283 | \$ 22,238 | 5.29% | \$ 878,801 | \$ 24,335 | 5.58% |
| Investment in securities: (3) | | | | | | |
| U.S. treasury | \$ 2,058 | \$ 16 | 1.56% | \$ 1,451 | \$ 13 | 1.81% |
| Government sponsored enterprises | 75,852 | 565 | 1.49 | 65,685 | 679 | 2.08 |
| Asset backed securities | 113,435 | 1,598 | 2.83 | 108,801 | 1,784 | 3.31 |
| State and municipal | 33,739 | 712 | 4.23 | 32,427 | 608 | 3.78 |
| Total Investment securities | \$ 225,084 | \$ 2,891 | 2.58% | \$ 208,364 | \$ 3,084 | 2.98% |
| Restricted Investments | 4,319 | 56 | 2.60 | 5,546 | 84 | 3.05 |
| Federal funds sold | 74 | | | 149 | | |
| Interest bearing deposits in other financial institutions | 28,399 | 37 | 0.26 | 23,721 | 32 | 0.27 |
| Total interest earning assets | \$ 1,101,159 | \$ 25,222 | 4.59% | \$ 1,116,581 | \$ 27,535 | 4.97% |
| All other assets | 101,859 | | | 99,110 | | |
| Allowance for loan losses | (14,320) | | | (13,670) | | |
| Total assets | \$ 1,188,698 | | | \$ 1,202,021 | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | |
| NOW accounts | \$ 192,003 | \$ 393 | 0.41% | \$ 187,155 | \$ 534 | 0.58% |
| Savings | 65,205 | 38 | 0.12 | 58,838 | 70 | 0.24 |
| Money market | 151,888 | 223 | 0.29 | 154,636 | 328 | 0.43 |
| Time deposits of \$100,000 and over | 132,566 | 537 | 0.81 | 125,909 | 896 | 1.44 |
| Other time deposits | 278,306 | 1,789 | 1.29 | 298,819 | 2,738 | 1.85 |
| Total time deposits | \$ 819,968 | \$ 2,980 | 0.73% | \$ 825,357 | \$ 4,566 | 1.12% |
| Federal funds purchased and securities sold under agreements to repurchase | 22,816 | 9 | 0.08 | 28,776 | 26 | 0.18 |
| Subordinated notes | 49,486 | 699 | 2.83 | 49,486 | 643 | 2.62 |
| Federal Home Loan Advances | 28,355 | 268 | 1.90 | 52,432 | 725 | 2.79 |
| Total borrowings | \$ 100,657 | \$ 976 | 1.94% | \$ 130,694 | \$ 1,394 | 2.15% |
| Total interest bearing liabilities | \$ 920,625 | \$ 3,956 | 0.86% | \$ 956,051 | \$ 5,960 | 1.26% |
| Demand deposits | 159,364 | | | 138,306 | | |
| Other liabilities | 8,283 | | | 4,974 | | |
| Total liabilities | 1,088,272 | | | 1,099,331 | | |

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| | | |
|---|---------------------|---------------------|
| Stockholders' equity | 100,426 | 102,690 |
| Total liabilities and stockholders' equity | \$ 1,188,698 | \$ 1,202,021 |
| Net interest income (FTE) | \$ 21,266 | \$ 21,575 |
| Net interest spread | 3.73% | 3.71% |
| Net interest margin | 3.87% | 3.90% |

- (1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 34%, net of nondeductible interest expense. Such adjustments totaled \$279,000 and \$312,000 for the six months ended June 30, 2012 and 2011, 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 and six months ended June 30, 2012 and 2011, respectively.

Financial results for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 reflected a decrease in net interest income, on a tax equivalent basis, of \$626,000, or 5.7%. Average interest-earning assets decreased \$11,428,000, or 1.0%, to \$1,098,046,000 for the three months ended June 30, 2012 compared to \$1,109,474,000 for the three months ended June 30, 2011 and average interest bearing liabilities decreased \$28,398,000, or 3.0%, to \$916,832,000 for the three months ended June 30, 2012 compared to \$945,230,000 for the three months ended June 30, 2011.

Average loans outstanding decreased \$25,185,000, or 2.9%, to \$847,022,000 for the three months ended June 30, 2012 compared to \$872,207,000 for the three months ended June 30, 2011. See the *Lending and Credit Management* section for further discussion of changes in the composition of our lending portfolio. Average investment securities and federal funds sold increased \$11,139,000, or 5.1%, to \$229,617,000 for the three months ended June 30, 2012 compared to \$218,478,000 for the three months ended June 30, 2011. Average interest bearing deposits in other financial institutions increased \$3,582,000 to \$17,104,000 for the three months ended June 30, 2012 compared to \$13,522,000 for the three months ended June 30, 2011. See the *Liquidity Management* section for further discussion.

Average time deposits decreased \$4,267,000 to \$815,919,000 for the three months ended June 30, 2012 compared to \$820,186,000 for the three months ended June 30, 2011. Average borrowings on Federal Home Loan Bank advances decreased \$19,661,000 to \$28,323,000 for the three months ended June 30, 2012 compared to \$47,984,000 for the three months ended June 30, 2011. See the *Liquidity Management* section for further discussion.

Financial results for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 reflected a decrease in net interest income, on a tax equivalent basis, of \$309,000, or 1.4%. Average interest-earning assets decreased \$15,422,000, or 1.4%, to \$1,101,159,000 for the six months ended June 30, 2012 compared to \$1,116,581,000 for the six months ended June 30, 2011 and average interest bearing liabilities decreased \$35,426,000, or 3.7%, to \$920,625,000 for the six months ended June 30, 2012 compared to \$956,051,000 for the six months ended June 30, 2011.

Average loans outstanding decreased \$35,518,000 or 4.0% to \$843,283,000 for the six months ended June 30, 2012 compared to \$878,801,000 for the six months ended June 30, 2011. See the *Lending and Credit Management* section for further discussion of changes in the composition of our lending portfolio. Average investment securities and federal funds sold increased \$16,645,000, or 8.0% to \$225,158,000 for the six months ended June 30, 2012 compared to \$208,513,000 for the six months ended June 30, 2011. Average interest bearing deposits in other financial institutions increased \$4,678,000 to \$28,399,000 for the six months ended June 30, 2012 compared to \$23,721,000 for the six months ended June 30, 2011. See the *Liquidity Management* section for further discussion.

Average time deposits decreased \$5,389,000 to \$819,968,000 for the six months ended June 30, 2012 compared to \$825,357,000 for the six months ended June 30, 2011. Average borrowings on Federal Home Loan Bank advances decreased \$24,077,000 to \$28,355,000 for the six months ended June 30, 2012 compared to \$52,432,000 for the six months ended June 30, 2011. See the *Liquidity Management* section for further discussion.

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, indentifying changes related to volumes and rates for the three and six months ended June 30, 2012, compared to the three and six months ended June 30, 2011. The change in interest due to the combined rate/volume variance has been allocated to rate and volume changes in proportion to the absolute dollar amounts of change in each.

| | Three Months Ended June 30, 2012 vs. 2011 | | | Six Months Ended June 30, 2012 vs. 2011 | | |
|--|--|-------------------|----------------------------------|--|-------------------|-----------------|
| | Total Change | Average Volume | Average Rate Change due to | Total Change | Average Volume | Average Rate |
| <i>(Dollars In thousands)</i> | | | | | | |
| Interest income on a fully taxable equivalent basis: | | | | | | |
| <u>Loans: (1) (3)</u> | | | | | | |
| Commercial | \$ (116) | \$ 10 | \$ (126) | \$ (198) | \$ 1 | \$ (199) |
| Real estate construction - residential | (193) | (140) | (53) | (150) | (301) | 151 |
| Real estate construction - commercial | (125) | (98) | (27) | (247) | (235) | (12) |
| Real estate mortgage - residential | 164 | 238 | (74) | 185 | 342 | (157) |
| Real estate mortgage - commercial | (709) | (288) | (421) | (1,552) | (680) | (872) |
| Consumer | (70) | (21) | (49) | (135) | (63) | (72) |
| <u>Investment securities:</u> | | | | | | |
| U.S. treasury | | 1 | (1) | 3 | 4 | (1) |
| Government sponsored entities | (62) | 33 | (95) | (114) | 95 | (209) |
| Asset backed securities | (196) | 6 | (202) | (186) | 74 | (260) |
| State and municipal(2) | (40) | 34 | (74) | 104 | 26 | 78 |
| Restricted Investments | (16) | (7) | (9) | (28) | (17) | (11) |
| Federal funds sold | | | | | | |
| Interest bearing deposits in other financial institutions | 4 | 3 | 1 | 5 | 6 | (1) |
| Total interest income | (1,359) | (229) | (1,130) | (2,313) | (748) | (1,565) |
| Interest expense: | | | | | | |
| NOW accounts | (54) | 5 | (59) | (141) | 14 | (155) |
| Savings | (17) | 4 | (21) | (32) | 7 | (39) |
| Money market | (47) | (2) | (45) | (105) | (6) | (99) |
| Time deposits of 100,000 and over | (125) | 4 | (129) | (359) | 45 | (404) |
| Other time deposits | (312) | (60) | (252) | (949) | (178) | (771) |
| Federal funds purchased and securities sold under agreements to repurchase | (8) | (2) | (6) | (17) | (4) | (13) |
| Subordinated notes | 22 | | 22 | 56 | | 56 |
| Other borrowed money | (192) | (111) | (81) | (457) | (271) | (186) |
| Total interest expense | (733) | (162) | (571) | (2,004) | (393) | (1,611) |
| Net interest income on a fully taxable equivalent basis | \$ (626) | \$ (67) | \$ (559) | \$ (309) | \$ (355) | \$ 46 |

(1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 34%, net of nondeductible interest expense. Such adjustments totaled \$137,000 and \$152,000 for the three months ended June 30, 2012 and 2011, respectively, and \$279,000 and \$312,000 for the six months ended June 30, 2012 and 2011, 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 decreased \$626,000, or 5.7%, to \$10,309,000 for the three months ended June 30, 2012 compared to \$10,935,000 for the three months ended June 30, 2011. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) decreased to 3.77% for the three months ended June 30, 2012 from 3.95% for the three months ended June 30, 2011. The decrease in net interest income was primarily the result of lower interest income earned on loans due to lower average balances and lower average rates. Our Company's net interest spread decreased to 3.61% for the three months ended June 30, 2012 from 3.78% for the three months ended June 30, 2011. The rates earned on interest earning assets decreased from 4.99% for the three months ended June 30, 2011 to 4.54% for the three months ended June 30, 2012. Slightly offsetting this decrease in rates earned was a decrease in interest expense incurred on deposits and other borrowings. Our Company's rates paid on interest bearing liabilities decreased to 0.93% for the three months ended June 30, 2012 compared to 1.21% for the three months ended June 30, 2011.

Net interest income on a fully taxable equivalent basis decreased \$309,000, or 1.4%, to \$21,266,000 for the six months ended June 30, 2012 compared to \$21,575,000 for the six months ended June 30, 2011. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) decreased to 3.87% for the six months ended June 30, 2012 from 3.90% for the six months ended June 30, 2011. The decrease in net interest income was primarily the result of lower interest income earned on loans due to lower average balances and lower average rates. Our Company's net interest spread slightly increased to 3.73% for the six months ended June 30, 2012 from 3.71% for the six months ended June 30, 2011. While rates earned on interest earning assets decreased from 4.97% for the six months ended June 30, 2011 to 4.59% for the six months ended June 30, 2012, rates paid on interest bearing liabilities decreased to 0.86% for the six months ended June 30, 2012 compared to 1.26% for the six months ended June 30, 2011. For the six months ended June 30, 2012, interest expense incurred on deposits and other borrowings decreased \$2,004,000 from the six months ended June 30, 2011. Effective January 1, 2012, our Company recorded a \$368,000 credit to interest expense on time deposits for imputed interest calculated on capitalized interest not accounted for during the time period of 2004 through 2011 on the construction of our Company's new bank buildings. This is considered a correction of an immaterial prior period error. Without this credit to interest expense, rates paid on interest bearing liabilities would have been approximately 0.94% for the six months ended June 30, 2012.

Non-interest Income and Expense

Non-interest income for the three and six months Ended June 30, 2012 and 2011 were as follows:

| (Dollars in thousands) | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|-----------------------------|-----------------|---------------|--------------|---------------------------|-----------------|---------------|-------------|
| | 2012 | 2011 | \$ Change | % Change | 2012 | 2011 | \$ Change | % Change |
| Non-interest Income | | | | | | | | |
| Service charges on deposit accounts | | | \$ | 2.9 | | | | |
| | \$ 1,460 | \$ 1,419 | \$ 41 | % | \$ 2,708 | \$ 2,730 | \$ (22) | \$(0.8)% |
| Trust department income | 224 | 229 | (5) | (2.2) | 436 | 424 | 12 | 2.8 |
| Gain on sales of mortgage loans | 475 | 216 | 259 | 119.9 | 994 | 462 | 532 | 115.2 |
| Other | 284 | 314 | (30) | (9.6) | 275 | 615 | (340) | (55.3) |
| Total non-interest income | \$ 2,443 | \$ 2,178 | \$ 265 | 12.2% | \$ 4,413 | \$ 4,231 | \$ 182 | 4.3% |
| Non-interest income as a % of total revenue * | | | | | | | | |
| | 19.4% | 16.8% | | | 17.4% | 16.6% | | |
| Total revenue per full time equivalent employee | | | | | | | | |
| | \$ 36.6 | \$ 38.2 | | | \$ 73.6 | \$ 75.2 | | |

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

On January 1, 2012, our Company opted to measure mortgage servicing rights at fair value as permitted by Accounting Standards Codification (ASC) Topic 860-50 *Accounting for Servicing Financial Assets*. The election of this option resulted in the recognition of a cumulative effect of change in accounting principle of \$459,890, which was recorded as an increase to beginning retained earnings, as further described in Note 5 to the consolidated financial statements. As such, effective January 1, 2012, the change in the fair value of mortgage servicing rights is recognized in earnings as other noninterest income for the period in which the change occurs.

Noninterest income increased \$265,000 or 12.2% to \$2,443,000 for the three months ended June 30, 2012 compared to \$2,178,000 for the three months ended June 30, 2011. The increase was primarily the result of a \$259,000 increase in the gains on sales of mortgage loans. Partially offsetting this increase was a \$66,000 decrease in real estate servicing income recorded in other noninterest income. As a result of the changes in fair value, during the three months ended June 30, 2012, \$218,000 was earned in real estate service fees, \$106,000 was recorded in real estate servicing income due to changes in model inputs and assumptions, and (\$333,000) was recorded due to other changes in fair value resulting from customer payments and passage of time. This is in comparison to the three months ended June 30, 2011 in which \$213,000 was earned in real estate servicing fees and \$155,000 of MSR amortization was recorded. The newly adopted accounting principle is preferable in the circumstances because the fair value measurement method will produce financial information and results more directly aligned with the performance of mortgage servicing rights. Our Company's loans sold increased from \$10,000,000 for the three months ended June 30, 2011 to \$19,000,000 for the three months ended June 30, 2012. Due to low interest rates, an increase in refinancing activity impacted both the volume of loans sold and gains recognized.

Noninterest income increased \$182,000 or 4.3% to \$4,413,000 for the six months ended June 30, 2012 compared to \$4,231,000 for the six months ended June 30, 2011. The increase was primarily the result of a \$532,000 increase on gains on sales of mortgage loans partially offset by a \$375,000 decrease in the real estate servicing income recorded in other noninterest income. As a result of the changes in fair value during the first six months of 2012, \$425,000 was earned in real estate service fees, \$275,000 was recorded in real estate servicing income due to changes in model inputs and assumptions, and (\$988,000) was recorded due to other changes in fair value resulting from customer payments and passage of time. This is in comparison to the six months ended June 30, 2011 in which \$393,000 was earned in real estate servicing fees and \$304,000 of MSR amortization was recorded. Our Company's loans sold increased from \$22,000,000 for the six months ended June 30, 2011 to \$40,000,000 for the six months ended June 30, 2012. As mentioned above, due to low interest rates, an increase in refinancing activity impacted both the volume of loans sold and gains recognized. Our Company was servicing \$306,000,000 of mortgage loans at June 30, 2012 compared to \$300,000,000 at June 30, 2011.

Non-interest expense for the three and six months Ended June 30, 2012 and 2011 were as follows:

| <i>(Dollars in thousands)</i> | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|--|-----------------------------|-----------------|-----------------|--------------|---------------------------|------------------|-----------------|-------------|
| | 2012 | 2011 | \$ Change | % Change | 2012 | 2011 | \$ Change | % Change |
| Non-interest Expense | | | | | | | | |
| Salaries | \$ 3,582 | \$ 3,233 | \$ 349 | 10.8% | \$ 7,088 | \$ 6,826 | \$ 262 | 3.8% |
| Employee benefits | 1,316 | 1,100 | 216 | 19.6 | 2,616 | 2,185 | 431 | 19.7 |
| Occupancy expense, net | 641 | 585 | 56 | 9.6 | 1,287 | 1,223 | 64 | 5.2 |
| Furniture and equipment expense | 468 | 509 | (41) | (8.1) | 971 | 1,016 | (45) | (4.4) |
| FDIC insurance assessment | 259 | 396 | (137) | (34.6) | 503 | 875 | (372) | (42.5) |
| Legal, examination, and professional fees | 259 | 307 | (48) | (15.6) | 596 | 798 | (202) | (25.3) |
| Advertising and promotion | 218 | 270 | (52) | (19.3) | 462 | 502 | (40) | (8.0) |
| Postage, printing, and supplies | 279 | 296 | (17) | (5.7) | 543 | 564 | (21) | (3.7) |
| Processing expense | 1,011 | 813 | 198 | 24.4 | 1,779 | 1,635 | 144 | 8.8 |
| Other real estate expense | 1,015 | 548 | 467 | 85.2 | 1,596 | 1,041 | 555 | 53.3 |
| Other | 1,050 | 951 | 99 | 10.4 | 2,137 | 1,721 | 416 | 24.2 |
| Total non-interest expense | \$ 10,098 | \$ 9,008 | \$ 1,090 | 12.1% | \$ 19,578 | \$ 18,386 | \$ 1,192 | 6.5% |
| Efficiency ratio | 80.0% | 69.5% | | | 77.1% | 72.1% | | |
| Salaries and benefits as a % of total non-interest expense | 48.5% | 48.1% | | | 49.6% | 49.0% | | |
| Number of full-time equivalent employees | 345 | 338 | | | 345 | 338 | | |

Total noninterest expense increased \$1,090,000, or 12.1%, to \$10,098,000 for the three months ended June 30, 2012 compared to \$9,008,000 for the three months ended June 30, 2011. Total noninterest expense increased \$1,192,000, or 6.5%, to \$19,578,000 for the six months ended June 30, 2012 compared to \$18,386,000 for the six months ended June 30, 2011.

Salary expense increased \$349,000, or 10.8%, to \$3,582,000 for the three months ended June 30, 2012 compared to \$3,233,000 for the three months ended June 30, 2011, and increased \$262,000, or 3.8%, to \$7,088,000 for the six months ended June 30, 2012 compared to \$6,826,000 for the six months ended June 30, 2011. The number of full-time equivalent employees increased from 338 at June 30, 2011 to 345 at June 30, 2012 partly due to the opening of a new lending location in Liberty, Missouri in May of 2012. A \$200,000 reversal of estimated accrued salary expense during the three-month period ended June 30, 2011 also contributed to this increase in salary expense for both the three month and six month periods ended June 30, 2012. Excluding this adjustment, salary expense for the three-month period ended June 30, 2012, increased \$163,000, or 4.9%, and salary expense for the six month period ended June 30, 2012, increased \$196,000, or 2.8%.

Employee benefits increased \$216,000, or 19.6%, to \$1,316,000 for the three months ended June 30, 2012 compared to \$1,100,000 for the three months ended June 30, 2011, and increased \$431,000, or 19.7%, to \$2,616,000 for the six months ended June 30, 2012 compared to \$6,826,000 for the six months ended June 30, 2011. The increase in employee benefits for the three months ended June 30, 2012 included \$20,000 increase in payroll taxes, an \$110,000 increase in estimated profit sharing and pension accrual, and a \$66,000 increase in other employee benefits compared to the three months ended June 30, 2011. The increase in employee benefits for the six months ended June 30, 2012 included a \$292,000 increase in estimated profit sharing and pension accrual, and a \$73,000 increase in other employee benefits.

Other real estate expense increased \$467,000, or 85.2%, to \$1,015,000 for the three months ended June 30, 2012 compared to \$548,000 for the three months ended June 30, 2011, and increased \$555,000, or 53.3%, for the six months ended June 30, 2012 compared to \$1,041,000 for the six months ended June 30, 2011. Other real estate expense for the three months ended June 30, 2012 increased primarily due to a \$486,000 expense provision for other real estate owned compared to \$280,000 for the three months ended June 30, 2011. Expenses incurred to maintain foreclosed properties during the three months ended June 30, 2012 increased \$310,000 in comparison to these for the three months ended June 30, 2011. These expenses were incurred primarily with respect to keeping two hotels in Branson in operating condition. During the six months ended June 30, 2012 the provision for other real estate owned was \$739,000 compared to \$441,000 for the six months ended June 30, 2011. Expenses incurred to maintain foreclosed properties during the six months ended June 30, 2012 increased \$322,000 in comparison to those for the six months ended June 30, 2011.

Processing expense increased \$198,000, or 24.4%, to \$1,011,000 for the three months ended June 30, 2012 compared to \$813,000 for the three months ended June 30, 2011, and increased \$144,000, or 8.8%, to \$1,779,000 for the six months ended June 30, 2012 compared to \$1,635,000 for the six months ended June 30, 2011. The increase in processing expense in both the three and six month periods primarily resulted from a one time reclassification during the second quarter of 2012 of \$116,000 of ATM and debit card income that was previously offset by the related expenses.

Federal Deposit Insurance Corporation (FDIC) insurance assessment decreased \$137,000, or 34.6%, to \$259,000 for the three months ended June 30, 2012 compared to \$396,000 for the three months ended June 30, 2011, and decreased \$372,000, or 42.5%, to \$503,000 for the six months ended June 30, 2012 compared to \$875,000 for the six months ended June 30, 2011. The decrease in FDIC insurance assessments was due to amendments made by the FDIC effective for the third quarter of 2011 to implement revisions to the Federal Deposit Insurance Act made by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The quarters ending after June 30, 2011 reflect a new assessment base using assets and tier one capital in the assessment calculation.

Legal, examination, and professional expenses decreased \$48,000, or 15.6%, to \$259,000 for the three months ended June 30, 2012 compared to \$307,000 for the three months ended June 30, 2011, and decreased \$202,000, or 25.3%, to \$596,000 for the six months ended June 30, 2012 compared to \$798,000 for the six months ended June 30, 2011. The decrease in legal, examination, and professional fees primarily resulted from a decrease in consulting fees due to a human resource best practices and profitability-consulting project completed during 2011.

Other noninterest expense increased \$99,000, or 10.4%, to \$1,050,000 for the three months ended June 30, 2012 compared to \$951,000 for the three months ended June 30, 2011, and increased \$416,000, or 24.2%, to \$2,137,000 for the six months ended June 30, 2012 compared to \$1,721,000 for the six months ended June 30, 2011. The noninterest expense increased due to a \$177,000 property donation during the first quarter of 2012 and a \$132,000 property donation during the second quarter of 2012 that were in other real estate owned to nonprofit organizations. Also included in noninterest expense for 2012 is \$88,000 of penalties assessed to our Company.

Income taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 27.3% for the three months ended June 30, 2012 compared to 32.0% for the three months ended June 30, 2011, and were 16.5% for the six months ended June 30, 2012 compared to 32.0% for the six months ended June 30, 2011. Excluding an immaterial correction of a prior period error of \$371,000, income taxes as a percentage of earnings before income taxes were 30.6% in comparison to 32.0% for the six months ended June 30, 2012 and 2011, respectively. As of December 31, 2011, our Company released \$28,000 of interest accrued related to the release of \$221,000 of uncertain tax provisions. As of June 30, 2012, our Company had not recognized any tax liabilities or any interest or penalties in income tax expense related to uncertain tax positions.

Lending and Credit Management

Interest earned on the loan portfolio is a primary source of interest income for our Company. Net loans represented 69.8% of total assets as of June 30, 2012 compared to 70.8% as of December 31, 2011, and 71.6% as of June 30, 2011.

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.

A summary of loans, by major class within our Company's loan portfolio as of the dates indicated is as follows:

| <i>(In thousands)</i> | June 30, 2012 Amount | December 31, 2011 Amount |
|---|-------------------------------------|---|
| Commercial, financial, and agricultural | \$ 128,858 | \$ 128,555 |
| Real estate construction - residential | 19,831 | 30,201 |
| Real estate construction - commercial | 42,841 | 47,697 |
| Real estate mortgage - residential | 220,334 | 203,454 |
| Real estate mortgage - commercial | 404,469 | 402,960 |
| Installment loans to individuals | 27,591 | 29,884 |
| Deferred fees and costs, net | 181 | 179 |
| Total loans | \$ 844,105 | \$ 842,930 |

Our Company's loan portfolio increased \$1,175,000, or 0.1%, from December 31, 2011 to June 30, 2012. During the six months ended June 30, 2012 there were no significant increases in loan demand. Our Company did experience an increase in refinancing during this time period due to low interest rates available for real estate mortgage residential properties. Also, during the first quarter of 2012 approximately \$10,000,000 of real estate construction residential loans were reclassified to real estate mortgage residential loans due to the completion of the construction phase.

The economy for the state of Missouri as a whole continues to be considered weak. Our Company anticipates several more quarters of slow growth and a very tight economy. As the State continues to look for places to balance its budget, our Company believes the economy in our central market could be impacted. The economy in the southern half of our Company's market area has been impacted by a tornado that struck the Branson area. Currently, the Branson area is experiencing good holiday weekends, but its economy is still struggling. Significant fluctuations in the stock market show little indication that the economy will stabilize and rebound soon. Although employment rates remain elevated, unemployment levels in our Company's market area have remained steady during the six months ended June 30, 2012. Borrowing rates have also remained at all time lows during our Company's thirty-six month analysis period. Management continues to focus on the improvement of asset quality by tightening underwriting standards and focusing on lending to credit worthy borrowers with the capacity to service their 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 U.S. FHFA House Price Index for March 2012 indicates house prices nationwide to be 19.4% below the April 2007 peak and 11.62% below that peak in Missouri. Our Company's market area compares favorably to other regions in the nation with increases as much as 1% while nationally the index declined 1.3%.

Our Company extends credit to its local community market through traditional real estate mortgage products. Our Company does not participate in extending credit to sub-prime residential real estate markets. 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 that 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.

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. For the six months ended June 30, 2012 our Company sold \$40,000,000 of loans to investors. At June 30, 2012, our Company was servicing approximately \$306,000,000 of loans sold to the secondary market.

Real estate mortgage loans retained in our Company's portfolio generally include provisions for rate adjustments at one to five 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 the 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, specific reserves are estimated 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 potential problem loans. Based upon these procedures, both the allowance and provision for loan losses are adjusted to maintain the allowance at a level considered necessary by management to provide for probable losses inherent in the loan portfolio.

Nonperforming Assets

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

| <i>(Dollars in thousands)</i> | June 30, 2012 | December 31, 2011 |
|--|--------------------------|------------------------------|
| Nonaccrual loans: | | |
| Commercial, financial, and agricultural | \$ 4,029 | \$ 2,068 |
| Real estate construction - residential | 280 | 1,147 |
| Real estate construction - commercial | 8,008 | 7,867 |
| Real estate mortgage - residential | 4,388 | 4,153 |
| Real estate mortgage - commercial | 22,666 | 31,000 |
| Installment loans to individuals | 159 | 168 |
| Total nonaccrual loans | 39,530 | 46,403 |
| Loans contractually past - due 90 days or more and still accruing: | | |
| Commercial, financial, and agricultural | | |
| Real estate construction - residential | | |
| Real estate construction - commercial | | 8 |
| Real estate mortgage - residential | 196 | 9 |
| Real estate mortgage - commercial | | 36 |
| Installment loans to individuals | | 1 |
| Total loans contractually past - due 90 days or more and still accruing | 196 | 54 |
| Troubled debt restructurings - accruing | 5,389 | 7,217 |
| Total nonperforming loans | 45,115 | 53,674 |
| Other real estate | 21,326 | 15,741 |
| Repossessions | 256 | 279 |
| Total nonperforming assets | \$ 66,697 | \$ 69,694 |
| Loans | \$ 844,105 | \$ 842,930 |
| Allowance for loan losses to loans | 1.81% | 1.64% |
| Nonperforming loans to loans | 5.34% | 6.37% |
| Allowance for loan losses to nonperforming loans | 33.94% | 25.73% |
| Nonperforming assets to loans and foreclosed assets | 7.70% | 8.11% |

Nonperforming loans, defined as loans on nonaccrual status, loans 90 days or more past due and still accruing, and restructured loans totaled \$45,115,000 or 5.34% of total loans at June 30, 2012 compared to \$53,674,000 or 6.37% of total loans at December 31, 2011.

It is our Company's policy to discontinue the accrual of interest income on loans when management believes that the borrower's financial condition, after consideration of business conditions and collection efforts, is such that the collection of interest is doubtful, or upon which principal or interest has been in default for a period of 90 days or more and the asset is not both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectability of such principal; otherwise, such receipts are recorded as interest income on a cash basis. Interest on nonaccrual loans, which would have been recorded under the original terms of the loans, was approximately \$483,000 and \$612,000 for the three months ended June 30, 2012 and 2011, respectively, and \$1,110,000 and \$1,219,000 for six months ended June 30, 2012 and 2011, respectively.

As of June 30, 2012 and December 31, 2011 approximately \$23,659,000 and \$11,676,000, respectively, of loans not included in the nonperforming asset table were identified by management as potential problem loans having more than normal risk which raised doubts as to the

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ability of the borrower to comply with present loan repayment terms. Borrowers are continuing to experience cash flow problems and as well as some deterioration in collateral value. Management believes the general allowance was sufficient to cover the risks and probable losses related to such loans at June 30, 2012 and December 31, 2011.

Total non-accrual loans at June 30, 2012 decreased \$6,873,000 from those at December 31, 2011. The decrease from December 31, 2011 primarily consisted of an \$8,334,000 decrease in real estate mortgage commercial non-accrual loans. This decrease was partially offset by a \$1,961,000 increase in commercial, financial and agricultural non-accrual loans. The

decreases primarily resulted from the foreclosure of five loans with balances totaling \$7,445,000 at December 31, 2011 that had been in nonaccrual status. The increase in commercial, financial and agricultural non-accrual loans resulted primarily from one significant loan relationship with a balance totaling \$1,279,000 at December 31, 2011 that was put on non-accrual status during the first three months of 2012. At June 30, 2012, real estate mortgage commercial non-accrual loans made up 57% of total non-accrual loans compared to 67% at December 31, 2011.

Loans past due 90 days and still accruing interest increased \$142,000 from December 31, 2011 to June 30, 2012. Foreclosed real estate and other repossessions increased \$5,562,000 from \$16,020,000 at December 31, 2011 to \$21,582,000 at June 30, 2012 primarily due to real estate mortgage commercial foreclosures.

At June 30, 2012, loans classified as troubled debt restructurings (TDRs) totaled \$28,328,000, of which \$22,939,000 were on non-accrual status and \$5,389,000 were on accrual status. At December 31, 2011, loans classified as TDRs totaled \$32,165,000, of which \$24,948,000 were on non-accrual status and \$7,217,000 were on accrual status.

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

| (Dollars in thousands) | June 30, 2012 | | | December 31, 2011 | | |
|--|---------------------|---------------------|-------------------|---------------------|---------------------|-------------------|
| | Number of contracts | Recorded Investment | Specific Reserves | Number of contracts | Recorded Investment | Specific Reserves |
| TDRs - Accrual | | | | | | |
| Commercial, financial and agricultural | 9 | \$ 2,356 | \$ 106 | 9 | \$ 2,360 | \$ 120 |
| Real estate construction - commercial | | | | | | |
| Real estate mortgage - residential | 5 | 592 | 88 | 20 | 2,416 | 61 |
| Real estate mortgage - commercial | 3 | 2,441 | | 3 | 2,441 | |
| Total | 17 | \$ 5,389 | \$ 194 | 32 | \$ 7,217 | \$ 181 |

| TDRs - Non-accrual | June 30, 2012 | | | December 31, 2011 | | |
|--|---------------------|---------------------|-------------------|---------------------|---------------------|-------------------|
| | Number of contracts | Recorded Investment | Specific Reserves | Number of contracts | Recorded Investment | Specific Reserves |
| Commercial, financial and agricultural | 2 | \$ 217 | \$ 20 | 2 | \$ 84 | \$ 52 |
| Real estate construction - commercial | 5 | 5,930 | 499 | 8 | 6,227 | 321 |
| Real estate mortgage - residential | 7 | 900 | 231 | 9 | 1,278 | 108 |
| Real estate mortgage - commercial | 14 | 15,892 | 639 | 15 | 17,359 | 860 |
| Total | 28 | \$ 22,939 | \$ 1,389 | 34 | \$ 24,948 | \$ 1,341 |
| Total TDRs | 45 | \$ 28,328 | \$ 1,583 | 66 | \$ 32,165 | \$ 1,522 |

Provision and Allowance for Loan Losses

As mentioned above, the economy continues to contribute to the deterioration of collateral values. The economic downturn and elevated unemployment rates in our market area have impaired the ability for certain of our customers to make payments on our loans in accordance with contractual terms.

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 necessary to cover probable losses in the loan portfolio. The allowance for loan losses increased to \$15,314,000 or 1.8% of loans outstanding at June 30, 2012 compared to \$13,863,000 or 1.6% of loans outstanding at June 30, 2011.

The following table summarizes loan loss experience for the three and six months ended as indicated:

| <i>(Dollars in thousands)</i> | Three Months Ended June | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|----------------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Analysis of allowance for loan losses: | | | | |
| Balance beginning of year | \$ 14,640 | \$ 12,402 | \$ 13,809 | \$ 14,565 |
| Net charge-offs: | | | | |
| Commercial, financial, and agricultural | 40 | 37 | (11) | 804 |
| Real estate construction - residential | (36) | (1) | (67) | 1,485 |
| Real estate construction - commercial | (23) | (250) | (23) | (250) |
| Real estate mortgage - residential | 383 | 434 | 486 | 1,465 |
| Real estate mortgage - commercial | 394 | 136 | 1,179 | 712 |
| Installment loans to individuals | 68 | 66 | 131 | 119 |
| Net charge-offs | 826 | 422 | 1,695 | 4,335 |
| Provision for loan losses | 1,500 | 1,883 | 3,200 | 3,633 |
| Balance at end of period | \$ 15,314 | \$ 13,863 | \$ 15,314 | \$ 13,863 |

The provision for loan losses decreased \$383,000 or 20.0% to \$1,500,000 for the three months ended June 30, 2012 compared to \$1,883,000 for the three months end June 30, 2011, and decreased \$433,000, or 12.0% to \$3,200,000 for the six months ended June 30, 2012 compared to \$3,633,000 for the six months ended June 30, 2011. Although net charge offs decreased \$2,640,000 during the six months ended June 30, 2012 in comparison to the six months ended June 30, 2011, the provision for loan losses remains significant due to the level of specific reserves and the historical loss rate based on our Company's last thirty-six months of charge off experience. Specific reserves on impaired loans were \$5,093,000 at June 30, 2012 in comparison to \$5,486,000 at June 30, 2011.

As shown in the table above, our Company's net loan charge-offs were \$826,000, or 0.10%, of average loans, for the three months ended June 30, 2012. In comparison, net loan charge-offs were \$422,000, or 0.05%, of average loans, for the three months ended June 30, 2011. Real estate residential net charge-offs represented 46% of second quarters net charge-offs and primarily related to one loan relationship that will be foreclosed on during the third quarter of 2012. Real estate mortgage commercial net charge-offs represented 48% of second quarter net charge-offs and primarily related to two loan relationships that will go to foreclosure during the third quarter of 2012.

As shown in the table above, our Company's net loan charge-offs were \$1,695,000, or 0.20%, of average loans, for the six months ended June 30, 2012. In comparison, net loan charge-offs were \$4,335,000, or 0.49%, of average loans, for the six months ended June 30, 2011. Net charge-offs for the six months ended June 30, 2012 continued to include significant write-downs on properties going to foreclosure to reflect current collateral values. Commercial, financial, and agricultural net charge-offs decreased \$815,000 to a net recovery of \$11,000 for the six months ended June 30, 2012 from a net charge-off of \$804,000 for the six months ended June 30, 2011. Real estate construction residential net charge-offs decreased \$1,552,000 to a net recovery of \$67,000 for the six months ended June 30, 2012 from a net charge-off of \$1,485,000 for the six months ended June 30, 2011. Real estate construction residential net charge offs during 2011 were primarily due to charge-offs taken on two credits for which management had specifically reserved \$2,000,000 as of December 31, 2010. Real estate mortgage residential net charge-offs decreased \$979,000 to \$486,000 for the six months ended June 30, 2012 from \$1,465,000 for the six months ended June 30, 2011. Partially offsetting these decreases, real estate mortgage commercial loan net charge-offs increased \$467,000 to \$1,179,000 at June 30, 2012 representing 70% of total net charges-offs for the six months ended June 30, 2012. This net charge-off primarily related to three significant commercial loan relationships that were in the foreclosure process during the six months ending June 30, 2012 totaling \$939,000.

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

The asset-specific reserve component applies to loans evaluated individually for impairment and is primarily based on management's best estimate of proceeds from liquidating collateral. The majority of our nonperforming loans are secured by real estate collateral. The actual timing and amount of repayments and the ultimate realizable value of the collateral may differ from management's estimate.

The incurred loss component of the general reserve is determined by applying percentages to pools of loans by asset type. These percentages are determined by using historical loss percentages. These incurred 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 incurred loss component discussed above. The evaluation of inherent loss with respect to these qualitative 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. Management believes that based on detailed analysis of each credit risk inherent to our loan portfolio and the value of any associated collateral, that the allowance for loan losses at June 30, 2012 is a reasonable estimate of probable losses incurred at that date.

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> | June 30, 2012 | December 31, 2011 |
|--|--------------------------|------------------------------|
| Allocation of allowance for loan losses at end of period: | | |
| Commercial, financial, and agricultural | \$ 3,045 | \$ 1,804 |
| Real estate construction - residential | 709 | 1,188 |
| Real estate construction - commercial | 1,644 | 1,562 |
| Real estate mortgage - residential | 3,560 | 3,251 |
| Real estate mortgage - commercial | 6,107 | 5,734 |
| Installment loans to individuals | 232 | 267 |
| Unallocated | 17 | 3 |
| Total | \$ 15,314 | \$ 13,809 |
| Percent of categories to total loans: | | |
| Commercial, financial, and agricultural | 15.3% | 15.3% |
| Real estate construction - residential | 2.3 | 3.6 |
| Real estate construction - commercial | 5.1 | 5.7 |
| Real estate mortgage - residential | 26.1 | 24.1 |
| Real estate mortgage - commercial | 47.9 | 47.8 |
| Installment loans to individuals | 3.3 | 3.5 |
| Total | 100.0% | 100.0% |

Our Company's allowance for loan losses increased \$1,505,000 from December 31, 2011 to June 30, 2012. The overall increase of the allowance for loan losses primarily consisted of a \$1,241,000 increase in the allocation for commercial, financial, and agricultural loans, a \$309,000 increase in the allocation for real estate mortgage residential loans, and a \$373,000 increase in the allocation for real estate mortgage commercial loans. Partially offsetting these increases was a \$479,000 decrease in the allocation for real estate construction residential loans. The ratio of the allowance for loan losses to nonperforming loans was 33.94% at June 30, 2012 compared to 25.73% at December 31, 2011.

At June 30, 2012, management determined that \$15,297,000 of the \$15,314,000 total allowance for loan losses represented asset-specific and incurred loss components and \$17,000 was unallocated. This compares to \$13,806,000 of the \$13,809,000 total allowance for loan losses allocated to asset-specific and incurred loss components and \$3,000 that was unallocated at December 31, 2011. Management's analysis of assessing the general reserve portion of the allowance for loan losses on a detailed level by homogeneous loan categories for loans not considered impaired, measures reserve requirements based on historical loss experiences for these certain types of loans and loan grades for the past twelve quarters.

The following table is a summary of the general and specific allocations within the allowance for loan losses:

| <i>(Dollars in thousands)</i> | June 30, 2012 | December 31, 2011 |
|---|--------------------------|------------------------------|
| Allocation of allowance for loan losses: | | |
| Specific reserve allocation for impaired loans | \$ 5,093 | \$ 3,747 |
| General reserve allocation for all other non-impaired loans | 10,221 | 10,062 |
| Total | \$ 15,314 | \$ 13,809 |

The asset-specific reserve component of our allowance for loan losses at June 30, 2012 was determined by using fair values of the underlying collateral through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. The general reserve component of our allowance for loan losses at June 30, 2012 was determined by calculating historical loss percentages for various loan categories over the previous twelve quarters. Management determined that the previous twelve quarters were reflective of the loss characteristics of our Company's loan portfolio during the recent economic downturn. Management realizes there are inherent weaknesses in relying solely on historical loss percentages and also considers qualitative factors in determining the allowance for loan losses. Internal factors management considers consist of underwriting standards, nature and volume of loans, lending staff experience, volume and severity of delinquencies and classified loans, loan review quality, value of underlying collateral, and concentrations of credit. Management also considers external factors such as economic conditions, market segments, regulatory and legal considerations, and competition. During the third quarter of 2011, management elected to further refine the methodology by distributing the previous quarter's unallocated reserve throughout the call report classes of loans by adding qualitative adjustments in addition to the historical loss rate applied to determine the expected probable loss requirement for the current portfolio. The specific and general allocations represent management's best estimate of probable losses contained in the loan portfolio at the evaluation date. Although the allowance for loan losses is comprised of specific and general allocations, the entire allowance is available to absorb any credit losses.

The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. Once the impairment amount is calculated, a specific reserve allocation is recorded. At June 30, 2012, \$5,093,000 of our Company's allowance for loan losses was allocated to impaired loans totaling approximately \$44,919,000 compared to \$3,747,000 of our Company's allowance for loan losses allocated to impaired loans totaling approximately \$53,619,000 at December 31, 2011. Based upon detailed analysis of all impaired loans, management has determined that \$16,798,000, or 37%, of impaired loans required no reserve allocation at June 30, 2012 compared to \$23,223,000, or 43%, at December 31, 2011.

Liquidity and Capital Resources

Liquidity Management

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

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

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

| <i>(dollars in thousands)</i> | June 30, 2012 | December 31, 2011 |
|--|--------------------------|------------------------------|
| Federal funds sold | \$ 75 | \$ 75 |
| Federal Reserve - excess reserves | 19,556 | 19,997 |
| Available for sale investment securities | 228,270 | 213,806 |
| Total | \$ 247,901 | \$ 233,878 |

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 \$228,270,000 at June 30, 2012 and included an unrealized net gain of \$5,671,000. The portfolio includes maturities of approximately \$5,372,000 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, federal funds purchase lines, securities sold under agreements to repurchase, borrowing capacity at the Federal Reserve Bank, and for other purposes required by law.

At June 30, 2012 total investment securities pledged for these purposes were as follows:

| <i>(dollars in thousands)</i> | June 30, 2012 | December 31, 2011 |
|---|--------------------------|------------------------------|
| Investment securities pledged for the purpose of securing: | | |
| Federal Reserve Bank borrowings | \$ 3,120 | \$ 1,819 |
| Repurchase agreements | 27,588 | 29,656 |
| Other deposits | 135,452 | 140,972 |
| Total pledged, at fair value | \$ 166,160 | \$ 172,447 |

At June 30, 2012 and December 31, 2011, our Company's unpledged securities in the available for sale portfolio totaled approximately \$62,110,000 and \$41,359,000, respectively.

Liquidity is available from our Company's base of core customer deposits, defined as demand, interest, checking, savings, and money market deposit accounts. At June 30, 2012, such deposits totaled \$571,654,000 and represented 58.1% 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 \$412,924,000 at June 30, 2012. These accounts are normally considered more volatile and higher costing representing 41.9% of total deposits at June 30, 2012.

| <i>(dollars in thousands)</i> | June 30, 2012 | December 31, 2011 |
|-------------------------------|--------------------------|------------------------------|
| Core deposit base: | | |
| Non-interest bearing demand | \$ 169,125 | \$ 159,187 |
| Interest checking | 185,378 | 169,452 |
| Savings and money market | 217,151 | 215,147 |
| Total | \$ 571,654 | \$ 543,786 |

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 securities sold under agreements to repurchase, FHLB advances, and subordinated notes as follows:

| <i>(dollars in thousands)</i> | June 30, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| Borrowings: | | |
| Securities sold under agreements to repurchase | \$ 23,844 | \$ 24,516 |
| FHLB advances | 28,281 | 28,410 |
| Subordinated notes | 49,486 | 49,486 |
| Total | \$ 101,611 | \$ 102,412 |

Federal funds purchased are overnight borrowings obtained mainly from upstream correspondent banks with which our Company maintains approved credit lines. As of June 30, 2012, under agreements with these unaffiliated banks, the Bank may borrow up to \$15,000,000 in federal funds on an unsecured basis and \$12,907,000 on a secured basis. There were no federal funds purchased outstanding at June 30, 2012. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of our Company's investment portfolio. At June 30, 2012 there was \$23,844,000 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 June 30, 2012. The Bank is a member of the Federal Home Loan Bank of Des Moines (FHLB). As a member of the FHLB, the Bank has access to credit products of the FHLB. As of June 30, 2012, the Bank had \$28,281,000 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 the advance equivalent of the assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to our Company as follows:

| <i>(dollars in thousands)</i> | June 30, 2012 | | | December 31, 2011 | | |
|-------------------------------|-------------------|----------------------------|--|-------------------|----------------------------|--|
| | FHLB | Federal Reserve Bank | Federal Funds Purchased Lines | FHLB | Federal Reserve Bank | Federal Funds Purchased Lines |
| Advance equivalent | \$ 272,712 | \$ 1,242 | \$ 26,665 | 263,199 | \$ 2,051 | \$ 25,402 |
| Advances outstanding | (28,281) | | | (43,657) | | |
| Letters of credit issued | | | | (206) | | |
| Total available | \$ 244,431 | \$ 1,242 | \$ 26,665 | 219,336 | \$ 2,051 | \$ 25,402 |

At June 30, 2012, loans with a market value of \$477,155,000 were pledged at the Federal Home Loan Bank as collateral for borrowings and letters of credit. At June 30, 2012, investments with a market value of \$17,863,000 were pledged to secure federal funds purchase lines and borrowing capacity at the Federal Reserve Bank.

Sources and Uses of Funds

Cash and cash equivalents were \$40,404,000 at June 30, 2012 compared to \$43,209,000 at December 31, 2011. The \$2,805,000 decrease resulted from changes in the various cash flows produced by operating, investing, and financing activities of our Company, as shown in the accompanying consolidated statement of cash flows for the six months ended June 30, 2012. Cash flow provided from operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of \$10,452,000 for the six months ended June 30, 2012.

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Investing activities consisting, mainly of purchases, sales and maturities of available for sale securities, and changes in the level of the loan portfolio, used total cash of \$25,598,000. The cash outflow primarily consisted of \$63,135,000 purchases of investment securities and a \$13,261,000 increase in the loan portfolio. Partially offsetting this increase was \$48,212,000 in proceeds from maturities, calls, and pay-downs of investment securities and \$3,084,000 in proceeds from sales of other real estate owned and repossessions

Financing activities provided cash of \$12,341,000, resulting primarily from a \$16,446,000 net increase in time deposits and interest-bearing transaction accounts and a \$9,938,000 increase in demand deposits. Partially offsetting this increase was the \$12,000,000 paid on the redemption of 12,000 shares of preferred stock. See Note 9 for further discussion. Future short-term liquidity needs arising from daily operations are not expected to vary significantly during 2012.

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 \$137,221,000 in unused loan commitments and standby letters of credit as of June 30, 2012. 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. For the six months ended June 30, 2012 and 2011, respectively, our Company paid cash dividends to its common and preferred shareholders totaling \$1,212,000 and \$1,204,000. A large portion of our Company's liquidity is obtained from the Bank in the form of dividends. The Bank declared and paid \$1,500,000 to our Company for each of the six months ended June 30, 2012 and 2011, respectively. At June 30, 2012 and 2011, our Company had cash and cash equivalents totaling \$1,251,000 and \$11,740,000 respectively.

Capital Management

Our Company and the 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 the 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 the 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 the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital to risk-weighted assets, and of Tier I capital to adjusted-average assets. Management believes, as of June 30, 2012 and December 31, 2011, our Company and the Bank each met all capital adequacy requirements to which they are subject.

The actual and required capital amounts and ratios for our Company and the Bank as of June 30, 2012 and December 31, 2011 follows:

| <i>(dollars in thousands)</i> | Actual | | Minimum | | Well-Capitalized | |
|---|------------|--------|--------------------------------|-------|--------------------------------|--------|
| | Amount | Ratio | Capital requirements Amount | Ratio | Capital Requirements Amount | Ratio |
| June 30, 2012 | | | | | | |
| Total capital (to risk-weighted assets): | | | | | | |
| Company | \$ 149,189 | 16.90% | \$ 70,637 | 8.00% | | |
| Hawthorn Bank | 132,492 | 15.29 | 69,328 | 8.00 | \$ 86,660 | 10.00% |
| Tier I capital (to risk-weighted assets): | | | | | | |
| Company | \$ 120,322 | 13.63% | \$ 35,318 | 4.00% | | |
| Hawthorn Bank | 121,610 | 14.03 | 34,664 | 4.00 | \$ 51,996 | 6.00% |
| Tier I capital (to adjusted average assets): | | | | | | |
| Company | \$ 120,322 | 10.17% | \$ 35,493 | 3.00% | | |
| Hawthorn Bank | 121,610 | 10.48 | 34,803 | 3.00 | \$ 58,006 | 5.00% |
| December 31, 2011 | | | | | | |
| Total capital (to risk-weighted assets): | | | | | | |
| Company | \$ 159,768 | 18.03% | \$ 70,905 | 8.00% | | |
| Hawthorn Bank | 130,398 | 15.00 | 69,567 | 8.00 | \$ 86,959 | 10.00% |
| Tier I capital (to risk-weighted assets): | | | | | | |
| Company | \$ 134,391 | 15.16% | \$ 35,453 | 4.00% | | |
| Hawthorn Bank | 119,498 | 13.74 | 34,784 | 4.00 | \$ 52,175 | 6.00% |
| Tier I capital (to adjusted average assets): | | | | | | |
| Company | \$ 134,391 | 11.52% | \$ 34,993 | 3.00% | | |
| Hawthorn Bank | 119,498 | 10.45 | 34,309 | 3.00 | \$ 57,181 | 5.00% |

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

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 three and six months ended June 30, 2012 our Company utilized a 400 basis point immediate and gradual move in interest rates (both upward and downward) applied to both a parallel and proportional yield curve.

The following table represents estimated interest rate sensitivity and periodic and cumulative gap positions calculated as of June 30, 2012:

| <i>(Dollars in thousands)</i> | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Over 5 years or no stated Maturity | Total |
|--|-------------------|-------------------|-------------------|------------------|------------------|---|---------------------|
| ASSETS | | | | | | | |
| Investment securities | \$ 30,036 | \$ 50,404 | \$ 59,381 | \$ 42,785 | \$ 23,969 | \$ 21,695 | \$ 228,270 |
| Interest-bearing deposits | 19,566 | | | | | | 19,566 |
| Other restricted investments | 4,288 | | | | | | 4,288 |
| Federal funds sold and securities purchased under agreements to resell | 75 | | | | | | 75 |
| Loans | 438,903 | 163,955 | 120,634 | 33,311 | 64,941 | 22,361 | 844,105 |
| Total | \$ 492,868 | \$ 214,359 | \$ 180,015 | \$ 76,096 | \$ 88,910 | \$ 44,056 | \$ 1,096,304 |
| LIABILITIES | | | | | | | |
| Savings, Now deposits | \$ | \$ | \$ 177,302 | \$ | \$ | \$ | \$ 177,302 |
| Rewards checking, Super Now, money market deposits | 225,228 | | | | | | 225,228 |
| Time deposits | 269,747 | 87,758 | 31,889 | 10,952 | 12,578 | | 412,924 |
| Federal funds purchased and securities sold under agreements to repurchase | 23,844 | | | | | | 23,844 |
| Subordinated notes | 49,486 | | | | | | 49,486 |
| Federal Home Loan Bank advances | 18,250 | 10,031 | | | | | 28,281 |
| Total | \$ 586,555 | \$ 97,789 | \$ 209,191 | \$ 10,952 | \$ 12,578 | \$ | \$ 917,065 |
| Interest-sensitivity GAP | | | | | | | |
| Periodic GAP | \$ (93,687) | \$ 116,570 | \$ (29,176) | \$ 65,144 | \$ 76,332 | \$ 44,056 | \$ 179,239 |
| Cumulative GAP | \$ (93,687) | \$ 22,883 | \$ (6,293) | \$ 58,851 | \$ 135,183 | \$ 179,239 | \$ 179,239 |
| Ratio of interest-earning assets to interest-bearing liabilities | | | | | | | |
| Periodic GAP | 0.84 | 2.19 | 0.86 | 6.95 | 7.07 | NM | 1.20 |
| Cumulative GAP | 0.84 | 1.03 | 0.99 | 1.07 | 1.15 | 1.20 | 1.20 |

Effects of Inflation

The effects of inflation on financial institutions are different from the effects on other commercial enterprises since financial institutions make few significant capital or inventory expenditures which are directly affected by changing prices. Because bank assets and liabilities are virtually

all monetary in nature, inflation does not affect a financial institution as much

as do changes in interest rates. The general level of inflation does underlie the general level of most interest rates, but interest rates do not increase at the rate of inflation as do prices of goods and services. Rather, interest rates react more to changes in the expected rate of inflation and to changes in monetary and fiscal policy.

Inflation does have an impact on the growth of total assets in the banking industry, often resulting in a need to increase capital at higher than normal rates to maintain an appropriate capital to asset ratio. In the opinion of management, inflation did not have a significant effect on our Company's operations for the three and six months ended June 30, 2012.

Item 4. Controls and Procedures

Our Company's management has evaluated, with the participation of our principal executive and principal financial officers, the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934 as of June 30, 2012. 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 three months ended June 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Impact of New Accounting Standards

Balance Sheet In December 2011, the FASB issued ASU No. 2011-11, *Disclosures about Offsetting Assets and Liabilities*, amending ASC Topic 210. The objective of this update is to provide enhanced disclosures that will enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on an entity's financial position. This includes the effects or potential effect of rights of setoff associated with an entity's recognized assets and recognized liabilities within the scope of this update. These amendments are effective for annual periods beginning on or after January 3, 2013, and interim periods within those annual periods and retrospectively require disclosures for all comparative periods presented. The adoption of ASU 2011-11 is not expected to have a material impact on our Company's consolidated financial statements.

PART II - OTHER INFORMATION

| | | |
|----------|--|------|
| Item 1. | Legal Proceedings | |
| | The information required by this Item is set forth in Note 13, <i>Pending Litigation</i> , in our Company's Notes to Consolidated Financial Statements (<i>unaudited</i>). | |
| 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. | Mine Safety Disclosures | 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 |

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- 101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Changes in Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to Consolidated Financial Statements, tagged as blocks of text and in detail (XBRL)

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/ David T. Turner

August 14, 2012

David T. Turner, Chairman of the Board and
Chief Executive Officer (Principal Executive Officer)

/s/ W. Bruce Phelps

August 14, 2012

W. Bruce Phelps, Chief Financial Officer (Principal
Financial Officer and Principal Accounting Officer)

HAWTHORN BANCSHARES, INC.

INDEX TO EXHIBITS

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Exhibit

| No. | Description | Page No. |
|-------|---|----------|
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* As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933, as amended, and Section 18 of the Securities Exchange Act of 1934, as amended.

** Incorporated by reference.