HAWTHORN BANCSHARES, INC.
Form 10-Q
August 15, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2016

or

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

Commission File Number: **0-23636**

HAWTHORN BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

Missouri	**43-1626350**
(State or other jurisdiction of	*(I.R.S. Employer*
incorporation or organization)	*Identification No.)*

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

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

(573) 761-6100

(Registrant’s telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of August 9, 2016, the registrant had 5,635,237 shares of common stock, par value $1.00 per share, outstanding

Part I - Financial Information

Item 1. Financial Statements

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets *(unaudited)*

(In thousands, except per share data)	**June 30, 2016**	**December 31, 2015**
ASSETS		
Cash and due from banks	$ 18,093	$ 20,484
Federal funds sold and other overnight interest-bearing deposits	18,939	7,893
Cash and cash equivalents	37,032	28,377
Investment in available-for-sale securities, at fair value	235,154	235,054
Other investments and securities, at cost	9,040	8,037
Total investment securities	244,194	243,091
Loans	922,942	865,080
Allowances for loan losses	(9,392)	(8,604)
Net loans	913,550	856,476
Premises and equipment - net	36,082	36,389
Mortgage servicing rights	2,511	2,847
Other real estate and repossessed assets - net	15,254	15,992
Accrued interest receivable	4,626	4,853
Cash surrender value - life insurance	2,379	2,348
Other assets	10,096	10,548
Total assets	$ 1,265,724	$ 1,200,921
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits		
Non-interest bearing demand	$ 217,777	$ 208,035
Savings, interest checking and money market	477,797	441,080
Time deposits $100,000 and over	149,734	132,244
Other time deposits	159,933	165,838
Total deposits	1,005,241	947,197
Federal funds purchased and securities sold under agreements to repurchase	35,694	56,834
Subordinated notes	49,486	49,486
Federal Home Loan Bank advances	74,000	50,000
Accrued interest payable	372	382
Other liabilities	9,190	9,736
Total liabilities	1,173,983	1,113,635
Stockholders’ equity:		
Common stock, $1 par value, authorized 15,000,000 shares; issued 5,605,202 shares, respectively	5,605	5,605

Surplus	41,709	38,549
Retained earnings	48,419	48,700
Accumulated other comprehensive loss, net of tax	(216)	(2,018)
Treasury stock; 179,313 and 164,013 shares, at cost	(3,776)	(3,550)
Total stockholders’ equity	91,741	87,286
Total liabilities and stockholders’ equity	$1,265,724	$ 1,200,921

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

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Income *(unaudited)*

(In thousands, except per share amounts)	**Three Months Ended June 30, 2016**	**2015**	**Six Months Ended June 30, 2016**	**2015**
INTEREST INCOME				
Interest and fees on loans	$ 10,308	$ 10,104	$ 20,295	$ 20,177
Interest on investment securities:				
Taxable	831	890	1,769	1,792
Nontaxable	119	172	262	355
Federal funds sold and other overnight interest-bearing deposits	17	8	50	22
Dividends on other securities	75	40	151	66
Total interest income	11,350	11,214	22,527	22,412
INTEREST EXPENSE				
Interest on deposits:				
Savings, interest checking and money market	287	247	582	497
Time deposit accounts $100,000 and over	232	222	441	431
Other time deposits	236	268	476	562
Interest on federal funds purchased and securities sold under agreements to repurchase	15	9	39	16
Interest on subordinated notes	366	320	720	633
Interest on Federal Home Loan Bank advances	243	164	450	311
Total interest expense	1,379	1,230	2,708	2,450
Net interest income	9,971	9,984	19,819	19,962
Provision for loan losses	425	250	675	250
Net interest income after provision for loan losses	9,546	9,734	19,144	19,712
NON-INTEREST INCOME				
Service charges and other fees	828	864	1,662	1,694
Bank card income and fees	648	629	1,282	1,216
Trust department income	265	274	483	478
Real estate servicing fees, net	(86)	186	(32)	180
Gain on sale of mortgage loans, net	222	434	387	781
Gain on sale of investment securities	18	8	490	8
Other	54	66	125	91
Total non-interest income	1,949	2,461	4,397	4,448
NON-INTEREST EXPENSE				
Salaries and employee benefits	5,305	5,175	10,655	10,478
Occupancy expense, net	673	717	1,306	1,380
Furniture and equipment expense	439	484	850	915
Processing, network, and bank card expense	840	807	1,611	1,596
Legal, examination, and professional fees	328	339	662	610
FDIC insurance assessment	188	258	364	499
Advertising and promotion	242	270	452	507

Postage, printing, and supplies	291	272	527	543
Real estate foreclosure expense (gains), net	42	158	183	(23)
Other	1,005	787	1,826	1,470
Total non-interest expense	9,353	9,267	18,436	17,975
Income before income taxes	2,142	2,928	5,105	6,185
Income tax expense	730	1,001	1,695	2,120
Net income	1,412	1,927	3,410	4,065
Basic earnings per share	$ 0.25	$ 0.34	$ 0.60	$ 0.72
Diluted earnings per share	$ 0.25	$ 0.34	$ 0.60	$ 0.72

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

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HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income *(unaudited)*

(In thousands)	**Three Months Ended June 30, 2016**	**2015**	**Six Months Ended June 30, 2016**	**2015**
Net income	$ 1,412	$ 1,927	$ 3,410	$ 4,065
Other comprehensive income (loss), net of tax				
Investment securities available-for-sale:				
Unrealized gain (loss) on investment securities available-for-sale, net of tax	837	(850)	2,082	(366)
Adjustment for gain on sale of investment securities, net of tax	(11)	(5)	(304)	(5)
Defined benefit pension plans:				
Amortization of prior service cost included in net periodic pension cost, net of tax	12	22	24	45
Total other comprehensive income (loss)	838	(833)	1,802	(326)
Total comprehensive income	$ 2,250	$ 1,094	$ 5,212	$ 3,739

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

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders' Equity *(unaudited)*

(In thousands)	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stock - holders' Equity
Balance, December 31, 2014	$ 5,396	$ 35,901	$ 44,016	$ (1,228)	$ (3,517)	$ 80,568
Net income	0	0	4,065	0	0	4,065
Other comprehensive loss	0	0	0	(326)	0	(326)
Stock dividend	0	2,847	(2,847)	0	0	0
Stock based compensation expense	0	5	0	0	0	5
Cash dividends declared, common stock	0	0	(523)	0	0	(523)
Balance, June 30, 2015	$ 5,396	$ 38,753	$ 44,711	$ (1,554)	$ (3,517)	$ 83,789
Balance, December 31, 2015	$ 5,605	$ 38,549	$ 48,700	$ (2,018)	$ (3,550)	$ 87,286
Net income	0	0	3,410	0	0	3,410
Other comprehensive income	0	0	0	1,802	0	1,802
Stock dividend	0	3,149	(3,149)	0	0	0
Stock based compensation expense	0	11	0	0	0	11
Purchases of treasury stock	0	0	0	0	(226)	(226)
Cash dividends declared, common stock	0	0	(542)	0	0	(542)
Balance, June 30, 2016	$ 5,605	$ 41,709	$ 48,419	$ (216)	$ (3,776)	$ 91,741

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

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows *(unaudited)*

	Six Months Ended June 30,	
(In thousands)	**2016**	**2015**
Cash flows from operating activities:		
Net income	$ 3,410	$ 4,065
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	675	250
Depreciation expense	962	962
Net amortization of investment securities, premiums, and discounts	883	664
Stock based compensation expense	11	5
Change in fair value of mortgage servicing rights	453	262
Gain on sale of investment securities	(490)	(8)
Gain on sales and dispositions of premises and equipment	(6)	(11)
Gain on sales and dispositions of other real estate and repossessed assets	(103)	(144)
Provision for other real estate owned	76	(6)
Decrease in accrued interest receivable	227	174
Increase in cash surrender value -life insurance	(31)	(35)
(Increase) decrease in other assets	(715)	1,344
Decrease in accrued interest payable	(10)	(8)
(Decrease) increase in other liabilities	(546)	195
Origination of mortgage loans for sale	(17,017)	(28,950)
Proceeds from the sale of mortgage loans	17,520	28,904
Gain on sale of mortgage loans, net	(387)	(781)
Other, net	(79)	(154)
Net cash provided by operating activities	4,833	6,728
Cash flows from investing activities:		
Net increase in loans	(59,499)	(2,494)
Purchase of available-for-sale debt securities	(76,417)	(67,583)
Proceeds from maturities of available-for-sale debt securities	24,457	14,245
Proceeds from calls of available-for-sale debt securities	10,035	10,875
Proceeds from sales of available-for-sale debt securities	44,300	720
Proceeds from sales of FHLB stock	0	120
Purchases of FHLB stock	(1,003)	(3,315)
Purchases of premises and equipment	(592)	(518)
Proceeds from sales of premises and equipment	6	11
Proceeds from sales of other real estate and foreclosed assets	2,399	1,036
Net cash used in investing activities	(56,314)	(46,903)
Cash flows from financing activities:		
Net increase (decrease) in demand deposits	9,742	(1,222)
Net increase in interest-bearing transaction accounts	36,717	23,194
Net increase (decrease) in time deposits	11,585	(2,620)
	(21,140)	7,872

Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase		
Repayment of FHLB advances	(8,000)	(13,000)
FHLB advances	32,000	17,000
Purchases of treasury stock	(226)	0
Cash dividends paid - common stock	(542)	(523)
Net cash provided by financing activities	60,136	30,701
Net increase (decrease) in cash and cash equivalents	8,655	(9,474)
Cash and cash equivalents, beginning of period	28,377	42,809
Cash and cash equivalents, end of period	$ 37,032	$ 33,335

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

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

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

	Six Months Ended June 30,	
(In thousands)	**2016**	**2015**
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	$ 2,718	$ 2,459
Income taxes	$ 1,975	$ 959
Noncash investing activities:		
Other real estate and repossessed assets acquired in settlement of loans	$ 1,634	$ 1,517

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

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(1) Summary of Significant Accounting Policies

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

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

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

Stock Dividend On July 1, 2016, the Company paid a special stock dividend of four percent to shareholders of record at the close of business on June 15, 2016. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

The following represents significant new accounting principles adopted in 2016:

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

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

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(2) Loans and Allowance for Loan Losses

Loans

A summary of loans, by major class within the Company's loan portfolio, at June 30, 2016 and December 31, 2015 is as follows:

(in thousands)	**June 30, 2016**	**December 31, 2015**
Commercial, financial, and agricultural	$160,124	$ 149,091
Real estate construction - residential	14,995	16,895
Real estate construction - commercial	46,218	33,943
Real estate mortgage - residential	250,588	256,086
Real estate mortgage - commercial	425,124	385,869
Installment and other consumer	25,893	23,196
Total loans	$922,942	$ 865,080

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the communities surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, Branson and the greater Kansas City metropolitan area. As such, the Bank is susceptible to changes in the economic environment in these communities. The Bank does not have a concentration of credit in any one economic sector. Installment and other consumer loans consist primarily of the financing of automotive vehicles. At June 30, 2016, loans with a carrying value of $446.7 million, or $369.8 million fair value, were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit.

Allowance for Loan Losses

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

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Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

Three Months Ended June 30, 2016

(in thousands)	Commercial, Financial, & Agriculture	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
Balance at beginning of period	$2,135	$ 44	$ 687	$ 2,273	$ 3,190	$ 259	$ 43	$8,631
Additions:								
Provision for loan losses	817	19	(929)	186	218	61	53	425
Deductions:								
Loans charged off	36	0	0	175	28	67	0	306
Less recoveries on loans	(80)	0	(491)	(9)	(31)	(31)	0	(642)
Net loans charged off	(44)	0	(491)	166	(3)	36	0	(336)
Balance at end of period	$2,996	$ 63	$ 249	$ 2,293	$ 3,411	$ 284	$ 96	$9,392

Six Months Ended June 30, 2016

(in thousands)	Commercial, Financial, & Agriculture	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
Balance at beginning of period	$2,153	$ 59	$ 644	$ 2,439	$ 2,935	$ 273	$ 101	$8,604
Additions:								
Provision for loan losses	804	4	(896)	218	495	55	(5)	675
Deductions:								
Loans charged off	138	0	1	381	111	123	0	754
Less recoveries on loans	(177)	0	(502)	(17)	(92)	(79)	0	(867)
Net loans charged off	(39)	0	(501)	364	19	44	0	(113)
Balance at end of period	$2,996	$ 63	$ 249	$ 2,293	$ 3,411	$ 284	$ 96	$9,392

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

	Three Months Ended June 30, 2015							
(in thousands)	**Commercial, Financial, & Agriculture**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment Loans to Individuals**	**Un-allocated**	**Total**
Balance at beginning of period	$2,141	$ 48	$ 374	$ 2,709	$ 4,115	$ 190	$ 184	$9,761
Additions:								
Provision for loan losses	1,065	(148)	45	(284)	(354)	66	(140)	250
Deductions:								
Loans charged off	122	0	5	140	8	113	0	388
Less recoveries on loans	(40)	(117)	0	(47)	(117)	(42)	0	(363)
Net loans charged off	82	(117)	5	93	(109)	71	0	25
Balance at end of period	$3,124	$ 17	$ 414	$ 2,332	$ 3,870	$ 185	$ 44	$9,986

	Six Months Ended June 30, 2015							
(in thousands)	**Commercial, Financial, & Agriculture**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment Loans to Individuals**	**Un-allocated**	**Total**
Balance at beginning of period	$1,779	$ 171	$ 466	$ 2,527	$ 3,846	$ 270	$ 40	$9,099
Additions:								
Provision for loan losses	880	(448)	(47)	(43)	(96)	0	4	250
Deductions:								
Loans charged off	150	0	5	211	32	161	0	559
Less recoveries on loans	(615)	(294)	0	(59)	(152)	(76)	0	(1,196)
Net loans (recovered) charged off	(465)	(294)	5	152	(120)	85	0	(637)
Balance at end of period	$3,124	$ 17	$ 414	$ 2,332	$ 3,870	$ 185	$ 44	$9,986

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

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

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Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

The following table provides the balance in the allowance for loan losses at June 30, 2016 and December 31, 2015, and the related loan balance by impairment methodology.

(in thousands)	Commercial, Financial, and Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
June 30, 2016								
Allowance for loan losses:								
Individually evaluated for impairment	$ 884	$ 0	$ 8	$ 628	$ 60	$ 14	$ 0	$ 1,594
Collectively evaluated for impairment	2,112	63	241	1,665	3,351	270	96	7,798
Total	$ 2,996	$ 63	$ 249	$ 2,293	$ 3,411	$ 284	$ 96	$ 9,392
Loans outstanding:								
Individually evaluated for impairment	$ 1,903	$ 0	$ 52	$ 5,030	$ 2,361	$ 99	$ 0	$ 9,445
Collectively evaluated for impairment	158,221	14,995	46,166	245,558	422,763	25,794	0	913,497
Total	$ 160,124	$ 14,995	$ 46,218	$ 250,588	$ 425,124	$ 25,893	$ 0	$ 922,942
December 31, 2015								
Allowance for loan losses:								
Individually evaluated for	$ 285	$ 0	$ 15	$ 955	$ 266	$ 19	$ 0	$ 1,540

impairment								
Collectively evaluated for impairment	1,868	59	629	1,484	2,669	254	101	7,064
Total	$ 2,153	$ 59	$ 644	$ 2,439	$ 2,935	$ 273	$ 101	$ 8,604
Loans outstanding:								
Individually evaluated for impairment	$ 1,005	$ 0	$ 102	$ 5,936	$ 3,081	$ 144	$ 0	$ 10,268
Collectively evaluated for impairment	148,086	16,895	33,841	250,150	382,788	23,052	0	854,812
Total	$ 149,091	$ 16,895	$ 33,943	$ 256,086	$ 385,869	$ 23,196	$ 0	$ 865,080

Impaired Loans

Loans evaluated under ASC 310-10-35 include loans which are individually evaluated for impairment. All other loans are collectively evaluated for impairment under ASC 450-20. Impaired loans individually evaluated for impairment totaled $9.4 million and $10.3 million at June 30, 2016 and December 31, 2015, respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings (TDRs).

The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At June 30, 2016 and December 31, 2015, $6.0 million and $6.4 million, respectively, of impaired loans were evaluated based on the fair value less estimated selling costs of the loan’s collateral. Once the impairment amount is calculated a specific reserve allocation is recorded. At June 30, 2016, $1.6 million of the Company’s allowance for loan losses was allocated to impaired loans totaling $9.4 million compared to $1.5 million of the Company's allowance for loan losses allocated to impaired loans totaling approximately $10.3 million at December 31, 2015. Management determined that $4.7 million, or 50%, of total impaired loans required no reserve allocation at June 30, 2016 compared to $4.5 million, or 44%, at December 31, 2015 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

The categories of impaired loans at June 30, 2016 and December 31, 2015 are as follows:

(in thousands)	June 30, 2016	December 31, 2015
Non-accrual loans	$ 3,647	$ 4,418
Performing TDRs	5,798	5,850
Total impaired loans	$ 9,445	$ 10,268

The following tables provide additional information about impaired loans at June 30, 2016 and December 31, 2015, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided.

(in thousands)	Recorded Investment	Unpaid Principal Balance	Specific Reserves
June 30, 2016			
With no related allowance recorded:			
Commercial, financial and agricultural	$ 296	$ 296	$ 0
Real estate - residential	2,355	2,356	0
Real estate - commercial	2,103	2,510	0
Total	$ 4,754	$ 5,162	$ 0
With an allowance recorded:			
Commercial, financial and agricultural	$ 1,607	$ 1,628	$ 884
Real estate - construction commercial	52	56	8
Real estate - residential	2,675	2,712	628
Real estate - commercial	258	329	60
Consumer	99	128	14
Total	$ 4,691	$ 4,853	$ 1,594
Total impaired loans	$ 9,445	$ 10,015	$ 1,594

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

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

	Three Months Ended June 30,				**Six Months Ended June 30,**			
	2016		**2015**		**2016**		**2015**	
(in thousands)	**Average Recorded Investment**	**Interest Recognized For the Period Ended**	**Average Recorded Investment**	**Interest Recognized For the Period Ended**	**Average Recorded Investment**	**Interest Recognized For the Period Ended**	**Average Recorded Investment**	**Interest Recognized For the Period Ended**
With no related allowance recorded:								
Commercial, financial and agricultural	$385	$ 19	$2,405	$ 8	$1,014	$ 29	$3,834	$ 13
Real estate - construction residential	0	0	0	0	0	0	1,105	0
Real estate - construction commercial	0	0	2,101	0	0	0	3,633	0
Real estate - residential	1,593	100	2,246	8	1,738	197	3,328	50
Real estate - commercial	2,109	63	4,081	21	2,280	120	11,383	65
Consumer	0	0	0	0	0	0	10	0
Total	$4,087	$ 182	$10,833	$ 37	$5,032	$ 346	$23,293	$ 128
With an allowance recorded:								
Commercial, financial and agricultural	$866	$ 108	$2,263	$ 7	$860	$ 135	$1,677	$ 6
Real estate - construction residential	0	0	0	0	0	0	565	0
Real estate - construction commercial	52	0	55	0	64	2	14	0
Real estate - residential	3,442	62	5,224	24	3,977	141	4,865	26
Real estate - commercial	260	13	1,360	0	560	20	2,056	0

Consumer	114	5	160	0	129	9	246	0
Total	$4,734	$ 188	$9,062	$ 31	$5,590	$ 307	$9,423	$ 32
Total impaired loans	$8,821	$ 370	$19,895	$ 68	$10,622	$ 653	$32,716	$ 160

The recorded investment varies from the unpaid principal balance primarily due to partial charge-offs taken resulting from current appraisals received. The amount recognized as interest income on impaired loans continuing to accrue interest, primarily related to troubled debt restructurings, was $370,000 and $653,000, for the three months and six months ended June 30, 2016, respectively, compared to $68,000 and $160,000 for the three and six months ended June 30, 2015, respectively. The average recorded investment in impaired loans is calculated on a monthly basis during the periods reported.

Delinquent and Non-Accrual Loans

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

The following table provides aging information for the Company’s past due and non-accrual loans at June 30, 2016 and December 31, 2015.

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(in thousands)	**Current or Less Than 30 Days Past Due**	**30 - 89 Days Past Due**	**90 Days Past Due And Still Accruing**	**Non-Accrual**	**Total**
June 30, 2016					
Commercial, Financial, and Agricultural	$ 158,398	$ 489	$ 0	$ 1,237	$ 160,124
Real Estate Construction - Residential	14,727	268	0	0	14,995
Real Estate Construction - Commercial	46,166	0	0	52	46,218
Real Estate Mortgage - Residential	247,872	1,299	0	1,417	250,588
Real Estate Mortgage - Commercial	423,960	323	0	841	425,124
Installment and Other Consumer	25,651	135	7	100	25,893
Total	$ 916,774	$ 2,514	$ 7	$ 3,647	$ 922,942
December 31, 2015					
Commercial, Financial, and Agricultural	$ 148,597	$ 185	$ 1	$ 308	$ 149,091
Real Estate Construction - Residential	16,895	0	0	0	16,895
Real Estate Construction - Commercial	33,776	65	0	102	33,943
Real Estate Mortgage - Residential	251,253	2,511	0	2,322	256,086
Real Estate Mortgage - Commercial	383,684	643	0	1,542	385,869
Installment and Other Consumer	22,840	207	5	144	23,196
Total	$ 857,045	$ 3,611	$ 6	$ 4,418	$ 865,080

Credit Quality

The Company categorizes loans into risk categories based upon an internal rating system reflecting management's risk assessment. Loans are placed on *watch* status when one or more weaknesses that may result in the deterioration of the repayment exits or the Company's credit position at some future date. Loans classified as *substandard* are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Loans so classified may have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. Such loans are characterized by the distinct possibility that the Company may sustain some loss if the deficiencies are not corrected. A loan is classified as a *troubled debt restructuring* (TDR) when a borrower is experiencing financial difficulties that lead to the restructuring of a loan, where the Company grants concessions to the borrower in the restructuring that it would not otherwise consider. Loans classified as TDRs which continue to accrue interest are classified as performing TDRs. Loans classified as TDRs which are not accruing interest are classified as nonperforming TDRs and are included with all other nonaccrual loans for presentation purposes. It is the Company’s policy to discontinue the accrual of interest income on loans when management believes that the collection of interest or principal is doubtful. Loans are placed on *non-accrual* status when (1) deterioration in the financial condition of the borrower exists for which payment of full principal and interest is not expected, or (2) payment of principal or interest has been in default for a period of 90 days or more and the asset is not both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectability of such principal; otherwise, such receipts are recorded as interest income on a cash basis.

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The following table presents the risk categories by class at June 30, 2016 and December 31, 2015.

(in thousands)	**Commercial, Financial, & Agricultural**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment and other Consumer**	**Total**
At June 30, 2016							
Watch	$ 10,876	$ 828	$ 1,187	$ 18,022	$ 43,747	$ 0	$74,660
Substandard	219	0	0	1,881	1,351	0	3,451
Performing TDRs	667	0	0	3,612	1,519	0	5,798
Non-accrual	1,237	0	52	1,417	841	100	3,647
Total	$ 12,999	$ 828	$ 1,239	$ 24,932	$ 47,458	$ 100	$87,556
At December 31, 2015							
Watch	$ 8,663	$ 1,267	$ 1,296	$ 22,191	$ 24,303	$ 186	$57,906
Substandard	421	0	37	3,737	1,485	36	5,716
Performing TDRs	697	0	0	3,615	1,538	0	5,850
Non-accrual	308	0	102	2,322	1,542	144	4,418
Total	$ 10,089	$ 1,267	$ 1,435	$ 31,865	$ 28,868	$ 366	$73,890

Troubled Debt Restructurings

At June 30, 2016, loans classified as TDRs totaled $6.0 million, of which $193,000 were classified as nonperforming TDRs and included in non-accrual loans and $5.8 million were classified as performing TDRs. At December 31, 2015, loans classified as TDRs totaled $6.4 million, of which $527,000 were classified as nonperforming TDRs and included in non-accrual loans and $5.9 million were classified as performing TDRs. Both performing and nonperforming TDRs are considered impaired loans. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the underlying collateral less applicable selling costs. Accordingly, specific reserves of $588,000 and $910,000 related to TDRs were allocated to the allowance for loan losses at June 30, 2016 and

December 31, 2015, respectively.

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

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	Three Months Ended June 30,					
	2016			**2015**		
	Recorded Investment (1)			**Recorded Investment (1)**		
(in thousands)	**Number of Contracts**	**Pre-Modification**	**Post-Modification**	**Number of Contracts**	**Pre-Modification**	**Post-Modification**
Troubled Debt Restructurings						
Commercial, financial and agricultural	0	$ 0	$ 0	0	$ 0	$ 0
Real estate mortgage - residential	0	0	0	1	366	355
Real estate mortgage - commercial	0	0	0	1	800	800
Total	0	$ 0	$ 0	2	$ 1,166	$ 1,155

	Six Months Ended June 30,					
	2016			**2015**		
	Recorded Investment (1)			**Recorded Investment (1)**		
(in thousands)	**Number of Contracts**	**Pre-Modification**	**Post-Modification**	**Number of Contracts**	**Pre-Modification**	**Post-Modification**
Troubled Debt Restructurings						
Commercial, financial and agricultural	0	$ 0	$ 0	3	$ 250	$ 240
Real estate mortgage - residential	1	78	78	3	510	464
Real estate mortgage - commercial	0	0	0	4	1,273	1,137
Total	1	$ 78	$ 78	10	$ 2,033	$ 1,841

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

The Company's portfolio of loans classified as TDRs include concessions for the borrower given financial condition such as interest rates below the current market rate, deferring principal payments, and extending maturity dates. There were no loans and one loan meeting the TDR criteria during the three and six months ended June 30, 2016, respectively, compared to two loans and ten loans during the three and six months ended June 30, 2015, respectively.

Upon default of a TDR, which is considered to be 90 days or more past due under the modified terms, impairment is measured based on the fair value of the underlying collateral less applicable selling costs. The impairment amount is either charged off as a reduction to the allowance for loan losses, provided for as a specific reserve within the allowance for loan losses, or in the process of foreclosure. There were no TDRs that defaulted within twelve months of its modification date during the three and six months ended June 30, 2016 and 2015, respectively. See *Lending and Credit Management* section for further information.

(3) Other Real Estate and Repossessed Assets

(in thousands)	**June 30, 2016**	**December 31, 2015**
Commercial	$ 830	$ 1,445
Real estate construction - commercial	12,380	12,380
Real estate mortgage - residential	1,144	477
Real estate mortgage - commercial	4,097	4,923
Repossessed assets	11	0
Total	$ 18,462	$ 19,225
Less valuation allowance for other real estate owned	(3,208)	(3,233)
Total other real estate and repossessed assets	$ 15,254	$ 15,992

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2016	**2015**	**2016**	**2015**
Balance at beginning of period	$ 18,696	$ 14,984	$ 19,225	$ 15,140
Additions	892	914	1,634	1,517
Proceeds from sales	(1,125)	(153)	(2,399)	(1,036)
Charge-offs against the valuation allowance for other real estate owned, net	(55)	0	(101)	(16)
Net gain on sales	54	4	103	144
Total other real estate and repossessed assets	$ 18,462	$ 15,749	$ 18,462	$ 15,749
Less valuation allowance for other real estate owned	(3,208)	(3,233)	(3,208)	(3,233)
Balance at end of period	$ 15,254	$ 12,516	$ 15,254	$ 12,516

At June 30, 2016, $146,000 of consumer mortgage loans secured by residential real estate properties were in the process of foreclosure compared to $390,000 at December 31, 2015.

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands)	**2016**	**2015**	**2016**	**2015**
Balance, beginning of period	$ 3,225	$ 3,233	$ 3,233	$ 3,233
Provision for other real estate owned	38	0	76	0
Charge-offs	(55)	0	(101)	0
Balance, end of period	$ 3,208	$ 3,233	$ 3,208	$ 3,233

(4) Investment Securities

The amortized cost and fair value of debt securities classified as available-for-sale at June 30, 2016 and December 31, 2015 were as follows:

(in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair value**
June 30, 2016				
Government sponsored enterprises	$ 38,824	$ 140	$ 1	38,963
Asset-backed securities	166,066	1,469	354	167,181
Obligations of states and political subdivisions	28,351	661	2	29,010
Total available-for-sale securities	$ 233,241	$ 2,270	$ 357	$ 235,154
December 31, 2015				
Government sponsored enterprises	$ 73,605	$ 127	$ 235	$ 73,497
Asset-backed securities	130,179	440	1,768	128,851
Obligations of states and political subdivisions	32,224	493	11	32,706
Total available-for-sale securities	$ 236,008	$ 1,060	$ 2,014	$ 235,054

All of the Company’s investment securities are classified as available for sale. Agency bonds and notes, agency mortgage-backed securities and agency collateralized mortgage obligations (CMO) include securities issued by the Government National Mortgage Association (GNMA), a U.S. government agency, and the Federal National Mortgage Association (FNMA), the

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Federal Home Loan Mortgage Corporation (FHLMC) and the Federal Home Loan Bank (FHLB), which are U.S. government-sponsored enterprises.

Other investments and securities primarily consist of Federal Home Loan Bank stock and the Company's interest in statutory trusts. These securities are reported at cost in the amount of $9.0 and $8.0 million as of June 30, 2016 and December 31, 2015, respectively.

Debt securities with carrying values aggregating approximately $209.3 million and $182.7 million at June 30, 2016 and December 31, 2015, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

The amortized cost and fair value of debt securities classified as available-for-sale at June 30, 2016, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without prepayment penalties.

(in thousands)	**Amortized Cost**	**Fair Value**
Due in one year or less	$ 15,119	$ 15,127
Due after one year through five years	41,357	41,771
Due after five years through ten years	10,169	10,544
Due after ten years	530	531
Total	67,175	67,973
Asset-backed securities	166,066	167,181
Total available-for-sale securities	$ 233,241	$ 235,154

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, 2016 and December 31, 2015 were as follows:

	Less than 12 months		**12 months or more**		**Total**	**Total**
(in thousands)	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
At June 30, 2016						
Government sponsored enterprises	$ 8,002	$ (1)	$ 0	$ 0	$ 8,002	$ (1)
Asset-backed securities	41,378	(244)	11,197	(110)	52,575	(354)
Obligations of states and political subdivisions	540	(2)	251	0	791	(2)
Total	$ 49,920	$ (247)	$ 11,448	$ (110)	$ 61,368	$ (357)
(in thousands)						
At December 31, 2015						
Government sponsored enterprises	$ 43,539	$ (222)	$ 1,002	$ (13)	$ 44,541	$ (235)
Asset-backed securities	56,095	(620)	43,576	(1,148)	99,671	(1,768)
Obligations of states and political subdivisions	2,571	(6)	718	(5)	3,289	(11)
Total	$ 102,205	$ (848)	$ 45,296	$ (1,166)	$ 147,501	$ (2,014)

The total available for sale portfolio consisted of approximately 277 securities at June 30, 2016. The portfolio included 29 securities having an aggregate fair value of $61.4 million that were in a loss position at June 30, 2016. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer had a fair value of $11.4 million at June 30, 2016. The $357,000 aggregate unrealized loss included in accumulated other comprehensive income at June 30, 2016 was caused by interest rate fluctuations.

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The total available for sale portfolio consisted of approximately 316 securities at December 31, 2015. The portfolio included 111 securities having an aggregate fair value of $147.5 million that were in a loss position at December 31, 2015. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer had a fair value of $45.3 million at December 31, 2015. The $2.0 million aggregate unrealized loss included in accumulated other comprehensive income at December 31, 2015 was caused by interest rate fluctuations.

Because the decline in fair value is attributable to changes in interest rates and not credit quality, these investments were not considered other-than-temporarily impaired at June 30, 2016 and December 31, 2015, respectively. In the absense of changes in credit quality of these investments, the fair value is expected to recover on all debt securities as they approach their maturity date, or re-pricing date or if market yields for such investments decline. In addition, the Company does not have the intent to sell these investments over the period of recovery, and it is not more likely than not that the Company will be required to sell such investment securities.

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands)	**2016**	**2015**	**2016**	**2015**
Gains realized on sales	$ 18	$ 8	$ 490	$ 8
Losses realized on sales	0	0	0	0
Other-than-temporary impairment recognized	0	0	0	0
Investment securities gains	$ 18	$ 8	$ 490	$ 8

(5) Intangible Assets

Mortgage Servicing Rights

At June 30, 2016, the Company was servicing approximately $304.7 million of loans sold to the secondary market compared to $312.1 million at December 31, 2015, and $312.6 million at June 30, 2015. Mortgage loan servicing fees, reported as non-interest income, earned on loans sold were $211,000 and $421,000 for the three and six months ended June 30, 2016, respectively, compared to $228,000 and $442,000 for the three and six months ended June 30, 2015, respectively.

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands)	**2016**	**2015**	**2016**	**2015**
Balance at beginning of period	$ 2,745	$ 2,662	$ 2,847	$ 2,762
Originated mortgage servicing rights	63	107	117	227
Changes in fair value:				
Due to change in model inputs and assumptions (1)	(142)	128	(145)	87
Other changes in fair value (2)	(155)	(170)	(308)	(349)
Balance at end of period	$ 2,511	$ 2,727	$ 2,511	$ 2,727

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

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

The following key data and assumptions were used in estimating the fair value of the Company’s MSRs as of the six months ended June 30, 2016 and 2015:

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	Six Months Ended June 30,			
	2016		2015	
Weighted average constant prepayment rate	12.16	%	10.66	%
Weighted average note rate	3.90	%	3.92	%
Weighted average discount rate	9.19	%	9.34	%
Weighted average expected life (in years)	5.10		5.70	

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

	June 30, 2016	December 31, 2015
Federal funds purchased	$0	$ 0
Repurchase agreements	35,694	56,834
Total	$35,694	$ 56,834

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

Repurchase Agreements	Remaining Contractual Maturity of the Agreements			
(in thousands)	Overnight and continuous	Less than 90 days	Greater than 90 days	Total

At June 30, 2016				
Government sponsored enterprises	$ 8,009	$ 0	$ 0	$ 8,009
Asset-backed securities	27,685	0	0	27,685
Total	$ 35,694	$ 0	$ 0	$ 35,694

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

(7) Income Taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 34.1% for the three months ended June 30, 2016 compared to 34.2% for the three months ended June 30, 2015. Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 33.2% for the six months ended June 30, 2016 compared to 34.3% for the six months ended June 30, 2015. The decrease in tax rates year over year is primarily due to an immaterial return to provision adjustment recorded in the first quarter of 2016.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income of the appropriate character during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, taxable income available in carryback years, and tax planning

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strategies in making this assessment. With the exception of certain capital losses generated during 2013 and 2014, it is management's opinion that the Company will more likely than not realize the benefits of these temporary differences as of June 30, 2016 and, therefore, only established a valuation reserve against the Company's capital loss carry forward. Management arrived at this conclusion 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. As indicated above, the Company generated approximately $219,000 of capital losses during 2013 and 2014 as a result of disposing of certain limited partnership interests. The capital losses will expire between 2019 and 2020, and it is management's opinion that the Company will not more likely than not generate the capital gain income necessary to utilize the capital loss carry forwards before the capital losses expire. As such, the Company has established an $83,000 valuation reserve against its capital loss carry forward deferred tax asset.

(8) Stockholders' Equity

Accumulated Other Comprehensive Loss

The following details the change in the components of the Company's accumulated other comprehensive income (loss) for the six months ended June 30, 2016 and 2015:

	Six months ended June 30, 2016		
(in thousands)	Unrealized Gain (Loss)	Unrecognized Net Pension and Postretirement Costs (2)	Accumulated Other Comprehensive (Loss) Income

	on Securities (1)		
Balance at beginning of period	$ (591)	$ (1,427)	$ (2,018)
Other comprehensive income (loss), before reclassifications	3,357	39	3,396
Amounts reclassified from accumulated other comprehensive income (loss)	(490)	0	(490)
Current period other comprehensive income, before tax	2,867	39	2,906
Income tax expense	(1,090)	(14)	(1,104)
Current period other comprehensive income, net of tax	1,777	25	1,802
Balance at end of period	$ 1,186	$ (1,402)	$ (216)

	Six months ended June 30, 2015		
(in thousands)	Unrealized Gain (Loss) on Securities (1)	Unrecognized Net Pension and Postretirement Costs (2)	Accumulated Other Comprehensive (Loss) Income
Balance at beginning of period	$ 214	$ (1,442)	$ (1,228)
Other comprehensive income (loss), before reclassifications	(591)	72	(519)
Amounts reclassified from accumulated other comprehensive income (loss)	(8)	0	(8)
Current period other comprehensive income (loss), before tax	(599)	72	(527)
Income tax benefit (expense)	228	(27)	201
Current period other comprehensive income (loss), net of tax	(371)	45	(326)
Balance at end of period	$ (157)	$ (1,397)	$ (1,554)

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

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

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(9) Employee Benefit Plans

Employee Benefits

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2016	2015	2016	2015
Payroll taxes	$ 336	$ 270	$ 632	$ 599
Medical plans	487	463	999	971
401k match and profit sharing	203	223	384	495
Pension plan	306	348	613	696
Other	46	24	62	43
Total employee benefits	$ 1,378	$ 1,328	$ 2,690	$ 2,804

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

Pension

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

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

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

	Estimated	Actual
(in thousands)	2016	2015
Service cost - benefits earned during the year	$ 1,179	$ 1,325
Interest costs on projected benefit obligations	956	838
Expected return on plan assets	(1,057)	(957)
Expected administrative expenses	70	40
Amortization of prior service cost	79	79
Amortization of unrecognized net loss	0	66
Net periodic pension expense	$ 1,227	$ 1,391
Pension expense - three months ended June 30, (actual)	$ 306	$ 348
Pension expense - six months ended June 30, (actual)	$ 613	$ 696

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(10) Stock Compensation

The Company's stock option plan provides for the grant of options to purchase up to 553,361 shares of the Company's common stock to officers and other key employees of the Company and its subsidiaries. All options have been granted at exercise prices equal to fair value and vest over periods ranging from four to five years.

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

	Number of Shares	Weighted average Exercise Price	Weighted Average Contractual Term (in years)	Aggregate Intrinsic Value ($000)
Outstanding, beginning of period	65,270	$ 20.68		
Granted	0	0.00		
Exercised	0	0.00		
Forfeited or expired	(20,812)	21.89		
Outstanding, June 30, 2016	44,458	$ 20.11	1.50	$ 0.00
Exercisable, June 30, 2016	36,675	$ 21.11	1.34	$ 0.00

Options have been adjusted to reflect a 4% stock dividend paid on July 1, 2016.

Total stock-based compensation expense was $5,000 and $11,000 for the three and six months ended June 30, 2016, respectively, compared to $0 and $5,000 for both the three and six months ended June 30, 2015, respectively. As of June 30, 2016, the total unrecognized compensation expense related to non-vested stock awards was $9,000 and the related weighted average period over which it is expected to be recognized is approximately 0.42 years.

(11) Earnings per Share

Stock Dividend On July 1, 2016, the Company paid a special stock dividend of 4% to common shareholders of record at the close of business on June 15, 2016. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in thousands, except per share data)	2016	2015	2016	2015
Basic earnings per share:				
Net income available to shareholders	$ 1,412	$ 1,927	$ 3,410	$ 4,065
Basic earnings per share	$ 0.25	$ 0.34	$ 0.60	$ 0.72
Diluted earnings per share:				
Net income available to shareholders	$ 1,412	$ 1,927	$ 3,410	$ 4,065
Average shares outstanding	5,645,270	5,660,499	5,648,664	5,660,499
Effect of dilutive stock options	0	0	0	0
Average shares outstanding including dilutive stock options				