HAWTHORN BANCSHARES, INC.
Form 10-Q
August 09, 2018

**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, 2018

OR

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

For the transition period from ______________to______________

Commission file number: 0-23636

**HAWTHORN BANCSHARES, INC.**

*(Exact name of registrant as specified in its charter)*

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

| **132 East High Street, Box 688, Jefferson City, Missouri** | **65102** |
|---|---|
| *(Address of principal executive offices)* | *(Zip Code)* |

**(573) 761-6100**
*(Registrant's telephone number, including area code)*

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

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

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

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

| | | |
|---|---|---|
| Large accelerated filer ¨ | Accelerated filer x | Non-accelerated filer ¨<br>(Do not check if a smaller reporting company) |
| Smaller reporting company ¨ | Emerging growth company ¨ | |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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, 2018, the registrant had 6,020,915 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, 2018 | December 31, 2017 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $15,921 | $ 23,325 |
| Federal funds sold and other interest-bearing deposits | 34,863 | 39,553 |
| Cash and cash equivalents | 50,784 | 62,878 |
| Certificates of deposit in other banks | 10,746 | 3,460 |
| Investment in available-for-sale securities, at fair value | 227,601 | 226,542 |
| Other investments and securities, at cost | 9,323 | 11,037 |
| Total investment securities | 236,924 | 237,579 |
| Loans | 1,094,195 | 1,068,432 |
| Allowances for loan losses | (11,212 ) | (10,852 ) |
| Net loans | 1,082,983 | 1,057,580 |
| Premises and equipment - net | 34,586 | 34,811 |
| Mortgage servicing rights | 2,813 | 2,713 |
| Other real estate owned and repossessed assets - net | 13,236 | 13,182 |
| Accrued interest receivable | 5,294 | 5,627 |
| Cash surrender value - life insurance | 2,516 | 2,484 |
| Other assets | 8,768 | 8,902 |
| Total assets | $1,448,650 | $ 1,429,216 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Deposits | | |
| Non-interest bearing demand | $250,232 | $ 245,380 |
| Savings, interest checking and money market | 614,976 | 584,468 |
| Time deposits $250,000 and over | 98,638 | 63,176 |
| Other time deposits | 219,540 | 232,788 |
| Total deposits | 1,183,386 | 1,125,812 |
| Federal funds purchased and securities sold under agreements to repurchase | 36,103 | 27,560 |
| Federal Home Loan Bank advances and other borrowings | 74,270 | 121,382 |
| Subordinated notes | 49,486 | 49,486 |
| Accrued interest payable | 790 | 554 |
| Other liabilities | 11,482 | 13,051 |
| Total liabilities | 1,355,517 | 1,337,845 |

| | | |
|---|---|---|
| Stockholders' equity: | | |
| Common stock, $1 par value, authorized 15,000,000 shares; issued 6,046,907 shares, respectively | 6,047 | 6,047 |
| Surplus | 50,456 | 45,442 |
| Retained earnings | 49,594 | 50,595 |
| Accumulated other comprehensive loss, net of tax | (7,734) | (5,662) |
| Treasury stock; 257,566 and 248,898 shares, at cost, respectively | (5,230) | (5,051) |
| Total stockholders' equity | 93,133 | 91,371 |
| Total liabilities and stockholders' equity | $1,448,650 | $ 1,429,216 |

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

2

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Income** *(unaudited)*

| (In thousands, except per share amounts) | Three Months Ended June 30, 2018 | 2017 | Six Months Ended June 30, 2018 | 2017 |
|---|---|---|---|---|
| INTEREST INCOME | | | | |
| Interest and fees on loans | $ 12,853 | $ 11,671 | $ 25,077 | $ 22,721 |
| Interest on investment securities: | | | | |
| Taxable | 984 | 737 | 1,930 | 1,491 |
| Nontaxable | 147 | 168 | 305 | 325 |
| Federal funds sold, other interest-bearing deposits, and certificates of deposit in other banks | 189 | 11 | 295 | 60 |
| Dividends on other securities | 115 | 94 | 225 | 184 |
| Total interest income | 14,288 | 12,681 | 27,832 | 24,781 |
| INTEREST EXPENSE | | | | |
| Interest on deposits: | | | | |
| Savings, interest checking and money market | 1,347 | 475 | 2,431 | 864 |
| Time deposit accounts $250,000 and over | 296 | 99 | 434 | 191 |
| Other time deposits | 536 | 410 | 1,046 | 789 |
| Interest on federal funds purchased and securities sold under agreements to repurchase | 189 | 27 | 360 | 49 |
| Interest on Federal Home Loan Bank advances | 332 | 419 | 728 | 741 |
| Interest on subordinated notes | 561 | 431 | 1,051 | 840 |
| Total interest expense | 3,261 | 1,861 | 6,050 | 3,474 |
| Net interest income | 11,027 | 10,820 | 21,782 | 21,307 |
| Provision for loan losses | 450 | 330 | 750 | 680 |
| Net interest income after provision for loan losses | 10,577 | 10,490 | 21,032 | 20,627 |
| NON-INTEREST INCOME | | | | |
| Service charges and other fees | 941 | 851 | 1,817 | 1,687 |
| Bank card income and fees | 709 | 663 | 1,365 | 1,277 |
| Trust department income | 311 | 266 | 592 | 540 |
| Real estate servicing fees, net | 161 | 34 | 381 | 487 |
| Gain on sale of mortgage loans, net | 242 | 218 | 387 | 374 |
| Other | 122 | 67 | 245 | 141 |
| Total non-interest income | 2,486 | 2,099 | 4,787 | 4,506 |
| NON-INTEREST EXPENSE | | | | |
| Salaries and employee benefits | 5,813 | 5,336 | 11,870 | 10,774 |
| Occupancy expense, net | 725 | 689 | 1,413 | 1,307 |
| Furniture and equipment expense | 685 | 634 | 1,320 | 1,232 |
| Processing, network, and bank card expense | 889 | 927 | 1,747 | 1,972 |
| Legal, examination, and professional fees | 201 | 317 | 624 | 597 |

| | | | | |
|---|---|---|---|---|
| FDIC insurance assessment | 146 | 115 | 301 | 216 |
| Advertising and promotion | 291 | 265 | 544 | 503 |
| Postage, printing, and supplies | 224 | 252 | 492 | 475 |
| Other | 957 | 1,152 | 1,875 | 1,961 |
| Total non-interest expense | 9,931 | 9,687 | 20,186 | 19,037 |
| Income before income taxes | 3,132 | 2,902 | 5,633 | 6,096 |
| Income tax expense | 225 | 983 | 636 | 2,076 |
| Net income | 2,907 | 1,919 | 4,997 | 4,020 |
| Basic earnings per share | $ 0.48 | $ 0.32 | $ 0.83 | $ 0.66 |
| Diluted earnings per share | $ 0.48 | $ 0.32 | $ 0.83 | $ 0.66 |

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

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive Income** *(unaudited)*

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In thousands)** | 2018 | 2017 | 2018 | 2017 |
| Net income | $ 2,907 | $ 1,919 | $ 4,997 | $ 4,020 |
| Other comprehensive income, net of tax | | | | |
| Investment securities available-for-sale: | | | | |
| Unrealized (loss) gain on investment securities available-for-sale, net of tax | (442 ) | 595 | (2,157 ) | 900 |
| Adjustment for gain on sale of investment securities, net of tax | 0 | 0 | 0 | 0 |
| Defined benefit pension plans: | | | | |
| Amortization of prior service cost included in net periodic pension cost, net of tax | 43 | 13 | 85 | 27 |
| Total other comprehensive (loss) income | (399 ) | 608 | (2,072 ) | 927 |
| Total comprehensive income | $ 2,508 | $ 2,527 | $ 2,925 | $ 4,947 |

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 Loss | Treasury Stock | Total Stock - holders' Equity |
|---|---|---|---|---|---|---|
| Balance, December 31, 2016 | $ 5,822 | $ 41,498 | $ 51,671 | $ (3,801) | $ (4,173) | $ 91,017 |
| Net income | 0 | 0 | 4,020 | 0 | 0 | 4,020 |
| Other comprehensive income | 0 | 0 | 0 | 927 | 0 | 927 |
| Stock based compensation expense | 0 | 2 | 0 | 0 | 0 | 2 |
| Purchase of treasury stock | 0 | 0 | 0 | 0 | (89) | (89) |
| Stock dividend | 0 | 4,165 | (4,165) | 0 | 0 | 0 |
| Cash dividends declared, common stock | 0 | 0 | (730) | 0 | 0 | (730) |
| Balance, June 30, 2017 | $ 5,822 | $ 45,665 | $ 50,796 | $ (2,874) | $ (4,262) | $ 95,147 |
| | | | | | | |
| Balance, December 31, 2017 | $ 6,047 | $ 45,442 | $ 50,595 | $ (5,662) | $ (5,051) | $ 91,371 |
| Net income | 0 | 0 | 4,997 | 0 | 0 | 4,997 |
| Other comprehensive loss | 0 | 0 | 0 | (2,072) | 0 | (2,072) |
| Purchase of treasury stock | 0 | 0 | 0 | 0 | (179) | (179) |
| Stock dividend | 0 | 5,014 | (5,014) | 0 | 0 | 0 |
| Cash dividends declared, common stock | 0 | 0 | (984) | 0 | 0 | (984) |
| Balance, June 30, 2018 | $ 6,047 | $ 50,456 | $ 49,594 | $ (7,734) | $ (5,230) | $ 93,133 |

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) | 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net income | $4,997 | $4,020 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 750 | 680 |
| Depreciation expense | 877 | 874 |
| Net amortization of investment securities, premiums, and discounts | 752 | 828 |
| Stock based compensation expense | 0 | 2 |
| Change in fair value of mortgage servicing rights | 31 | (67) |
| Gain on sale of investment securities | (206) | 0 |
| (Gain) loss on sales and dispositions of premises and equipment | (13) | 1 |
| Gain on sales and dispositions of other real estate and repossessed assets | (2) | (38) |
| Provision for other real estate owned | 26 | 215 |
| Decrease in accrued interest receivable | 333 | 429 |
| Increase in cash surrender value - life insurance | (32) | (39) |
| Decrease (increase) in other assets | 873 | (545) |
| Increase (decrease) in accrued interest payable | 236 | (69) |
| (Decrease) increase in other liabilities | (1,742) | 290 |
| Origination of mortgage loans for sale | (19,597) | (17,101) |
| Proceeds from the sale of mortgage loans | 19,722 | 16,154 |
| Gain on sale of mortgage loans, net | (387) | (374) |
| Other, net | (131) | (115) |
| Net cash provided by operating activities | 6,487 | 5,145 |
| Cash flows from investing activities: | | |
| Net (increase) decrease in certificates of deposit in other banks | (7,286) | 1,000 |
| Net increase in loans | (26,272) | (59,846) |
| Purchase of available-for-sale debt securities | (74,275) | (21,874) |
| Proceeds from maturities of available-for-sale debt securities | 16,445 | 16,132 |
| Proceeds from calls of available-for-sale debt securities | 1,685 | 4,525 |
| Proceeds from sales of available-for-sale debt securities | 51,810 | 0 |
| Purchases of FHLB stock | (1,370) | (1,203) |
| Proceeds from sales of FHLB stock | 3,084 | 201 |
| Purchases of premises and equipment | (734) | (863) |
| Proceeds from sales of premises and equipment | 13 | 0 |
| Proceeds from sales of other real estate and foreclosed assets | 304 | 784 |
| Net cash used in investing activities | (36,596) | (61,144) |
| Cash flows from financing activities: | | |
| Net increase in demand deposits | 4,851 | 43,659 |
| Net increase in interest-bearing transaction accounts | 30,509 | 48,947 |
| Net increase (decrease) in time deposits | 22,214 | (20,585) |
| | 8,543 | (2,389) |

| | | |
|---|---|---|
| Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase | | |
| Repayment of FHLB advances and other borrowings | (141,112) | (130,277) |
| FHLB advances | 94,000 | 152,740 |
| Purchase of treasury stock | (179) | (89) |
| Cash dividends paid - common stock | (811) | (674) |
| Net cash provided by financing activities | 18,015 | 91,332 |
| Net (decrease) increase in cash and cash equivalents | (12,094) | 35,333 |
| Cash and cash equivalents, beginning of period | 62,878 | 25,995 |
| Cash and cash equivalents, end of period | $50,784 | $61,328 |

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

6

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

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

| | **Six Months Ended June 30,** | |
|---|---|---|
| (In thousands) | 2018 | 2017 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the year for: | | |
| Interest | $5,814 | $3,542 |
| Income taxes | $50 | $2,185 |
| Noncash investing activities: | | |
| Other real estate and repossessed assets acquired in settlement of loans | $382 | $155 |

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 Missouri 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, 2017.

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, 2018, the Company paid a special stock dividend of four percent to shareholders of record at the close of business on June 15, 2018. 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 2018:**

***Revenue from Contracts with Customers*** On January 1, 2018, the Company adopted ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* and all subsequent ASUs that modified Topic 606. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with historic accounting under Topic 605.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, derivatives, and certain credit card fees are also not in scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as trust department revenue, service charges and fees, debit card income, ATM surcharge income, and other real estate owned sales. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Noninterest revenue streams within the scope of Topic 606 are discussed in Footnote 16.

***Financial Instruments*** The FASB issued ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, in January 2016. The amendments require all equity investments to be measured at fair value with changes in the fair value recognized through net income, other than those accounted for under the equity method of accounting or those that result in the consolidation of the investee. Additionally, these amendments require presentation in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk for those liabilities measured at fair value. The amendments also require use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes. These amendments are effective for interim and annual periods beginning January 1, 2018. The adoption of the ASU 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)*

The FASB issued ASU 2018-04, *Investments - Debt Securities (Topic 320) and Regulated Operations (Topic 980)*: The amendment in this ASU adds, amends and supersedes various paragraphs that contain SEC guidance in ASC 320, Investments-Debt Securities and ASC 980, Regulated Operations. The amendments in this ASU are effective when a registrant adopts ASU 2016-01, which for the Company was January 1, 2018. This amendment did not have a significant effect on the Company's consolidated financial statements.

***Liabilities*** The FASB issued ASU 2016-04, *Recognition of Breakage for Certain Prepaid Store-Value Products*, in March 2016, in order to address current and potential future diversity in practice related to the derecognition of a prepaid store-value product liability. Such products include prepaid gift cards issued on a specific payment network and redeemable at network-accepting merchant locations, prepaid telecommunication cards, and traveler's checks. The amendments require that the portion of the dollar value of prepaid stored-value products that is ultimately unredeemed (that is, the breakage) be accounted for consistent with the breakage guidance for stored-value product transactions provided in ASC Topic 606 - Revenue from Contracts with Customers. These amendments are effective for interim and annual periods beginning January 1, 2018. The adoption of the ASU did not have a significant effect on the Company's consolidated financial statements.

***Pension*** The FASB issued ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost* in March 2017. Under the new guidance, employers will present the service cost component of the net periodic benefit cost in the same income statement line item (e.g., Salaries and Benefits) as other employee compensation costs arising from services rendered during the period. In addition, only the service cost component will be eligible for capitalization in assets. Employers will present the other components separately (e.g., Other Noninterest Expense) from the line item that includes the service cost. The ASU is effective for interim and annual reporting periods beginning after December 15, 2017. Employers will apply the guidance on the presentation of the components of net periodic benefit cost in the income statement retrospectively. The guidance limiting the capitalization of net periodic benefit cost in assets to the service cost component will be applied prospectively. The Company utilizes the ASU’s practical expedient allowing entities to estimate amounts for comparative periods using the information previously disclosed in their pension and other postretirement benefit plan footnote. The adoption of the ASU did not have a significant effect on the Company's consolidated financial statements.

(2) Loans and Allowance for Loan Losses

*Loans*

A summary of loans, by major class within the Company's loan portfolio, at June 30, 2018 and December 31, 2017 is as follows:

| (in thousands) | June 30, 2018 | December 31, 2017 |
| --- | --- | --- |
| Commercial, financial, and agricultural | $200,628 | $ 192,238 |
| Real estate construction - residential | 28,285 | 26,492 |
| Real estate construction - commercial | 106,406 | 98,340 |
| Real estate mortgage - residential | 246,415 | 246,754 |
| Real estate mortgage - commercial | 479,571 | 472,455 |
| Installment and other consumer | 32,890 | 32,153 |
| Total loans | $1,094,195 | $ 1,068,432 |

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the Missouri 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, 2018, loans of $489.6 million were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit.

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

*Allowance for Loan Losses*

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

| | Three Months Ended June 30, 2018 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (in thousands) | Commercial, Financial, & Agriculture | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment and Other Consumer | Un-allocated | Total |
| Balance at beginning of period | $3,261 | $ 240 | $ 895 | $ 2,057 | $ 4,008 | $ 352 | $ 134 | $10,947 |
| Additions: | | | | | | | | |
| Provision for loan losses | 865 | (52) | 10 | 48 | (388) | 90 | (123) | 450 |
| Deductions: | | | | | | | | |
| Loans charged off | 193 | 0 | 0 | 12 | 15 | 49 | 0 | 269 |
| Less recoveries on loans | (10) | (13) | 0 | (16) | (25) | (20) | 0 | (84) |
| Net loan charge-offs (recoveries) | 183 | (13) | 0 | (4) | (10) | 29 | 0 | 185 |
| Balance at end of period | $3,943 | $ 201 | $ 905 | $ 2,109 | $ 3,630 | $ 413 | $ 11 | $11,212 |

| | Six Months Ended June 30, 2018 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (in thousands) | Commercial, Financial, & Agriculture | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment and Other Consumer | Un-allocated | Total |
| | $3,325 | $ 170 | $ 807 | $ 1,689 | $ 4,437 | 345 | $ 79 | $10,852 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Balance at beginning of period | | | | | | | | |
| Additions: | | | | | | | | |
| Provision for loan losses | 898 | 54 | 128 | 416 | (809) | 131 | (68) | 750 |
| Deductions: | | | | | | | | |
| Loans charged off | 303 | 48 | 30 | 32 | 29 | 106 | 0 | 548 |
| Less recoveries on loans | (23) | (25) | 0 | (36) | (31) | (43) | 0 | (158) |
| Net loan charge-offs (recoveries) | 280 | 23 | 30 | (4) | (2) | 63 | 0 | 390 |
| Balance at end of period | $3,943 | $ 201 | $ 905 | $ 2,109 | $ 3,630 | $ 413 | $ 11 | $11,212 |

| | Three Months Ended June 30, 2017 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (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 | Un-allocated | Total |
| Balance at beginning of period | $2,360 | $ 99 | $ 579 | $ 2,125 | $ 4,731 | $ 322 | $ 46 | $10,262 |
| Additions: | | | | | | | | |
| Provision for loan losses | 226 | (54) | 36 | (230) | 139 | 89 | 124 | 330 |
| Deductions: | | | | | | | | |
| Loans charged off | 32 | 0 | 0 | 62 | 2 | 60 | 0 | 156 |
| Less recoveries on loans | (24) | (25) | 0 | (21) | (14) | (25) | 0 | (109) |
| Net loan charge-offs (recoveries) | 8 | (25) | 0 | 41 | (12) | 35 | 0 | 47 |
| Balance at end of period | $2,578 | $ 70 | $ 615 | $ 1,854 | $ 4,882 | $ 376 | $ 170 | $10,545 |

| | Six Months Ended June 30, 2017 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (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 | Un-allocated | Total |
| Balance at beginning of period | $2,753 | $ 108 | $ 413 | $ 2,385 | $ 3,793 | 274 | $ 160 | $9,886 |
| Additions: | | | | | | | | |
| Provision for loan losses | (157) | (113) | 202 | (507) | 1,084 | 161 | 10 | 680 |
| Deductions: | | | | | | | | |
| Loans charged off | 60 | 0 | 0 | 81 | 16 | 111 | 0 | 268 |
| Less recoveries on loans | (42) | (75) | 0 | (57) | (21) | (52) | 0 | (247) |
| Net loan charge-offs (recoveries) | 18 | (75) | 0 | 24 | (5) | 59 | 0 | 21 |
| Balance at end of period | $2,578 | $ 70 | $ 615 | $ 1,854 | $ 4,882 | $ 376 | $ 170 | $10,545 |

Loans, or portions of loans, are charged off to the extent deemed uncollectible or a loss is confirmed. Loan charge-offs reduce the allowance for loan losses, and recoveries of loans previously charged off are added back to the allowance. If management determines that it is probable that all amounts due on a loan will not be collected under the original

terms of the loan agreement, the loan is considered to be impaired. These loans are evaluated individually for impairment, and in conjunction with current economic conditions and loss experience, specific reserves are estimated as further discussed below. Loans not individually evaluated are aggregated by risk characteristics and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type, delinquencies, current economic conditions, loan risk ratings and industry concentration.

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

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. 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. As of December 31, 2017, the Company utilized a five-year look-back period.

The following table provides the balance in the allowance for loan losses at June 30, 2018 and December 31, 2017, 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 and Other **Consumer** | Un- **allocated** | **Total** |
|---|---|---|---|---|---|---|---|---|
| June 30, 2018 | | | | | | | | |
| Allowance for loan losses: | | | | | | | | |
| Individually evaluated for impairment | $ 410 | $ 0 | $ 0 | $ 668 | $ 185 | $ 19 | $ 0 | $ 1,282 |
| Collectively evaluated for impairment | 3,533 | 201 | 905 | 1,441 | 3,445 | 394 | 11 | 9,930 |
| Total | $ 3,943 | $ 201 | $ 905 | $ 2,109 | $ 3,630 | $ 413 | $ 11 | $ 11,212 |
| Loans outstanding: | | | | | | | | |
| Individually evaluated for impairment | $ 2,887 | $ 0 | $ 169 | $ 5,186 | $ 1,705 | $ 304 | $ 0 | $ 10,251 |
| | 197,741 | 28,285 | 106,237 | 241,229 | 477,866 | 32,586 | 0 | 1,083,944 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Collectively evaluated for impairment | | | | | | | | |
| Total | $ 200,628 | $ 28,285 | $ 106,406 | $ 246,415 | $ 479,571 | $ 32,890 | $ 0 | $ 1,094,195 |
| December 31, 2017 | | | | | | | | |
| Allowance for loan losses: | | | | | | | | |
| Individually evaluated for impairment | $ 500 | $ 0 | $ 48 | $ 521 | $ 243 | $ 21 | $ 0 | $ 1,333 |
| Collectively evaluated for impairment | 2,825 | 170 | 759 | 1,168 | 4,194 | 324 | 79 | 9,519 |
| Total | $ 3,325 | $ 170 | $ 807 | $ 1,689 | $ 4,437 | $ 345 | $ 79 | $ 10,852 |
| Loans outstanding: | | | | | | | | |
| Individually evaluated for impairment | $ 3,007 | $ 0 | $ 97 | $ 5,072 | $ 2,004 | $ 176 | $ 0 | $ 10,356 |
| Collectively evaluated for impairment | 189,231 | 26,492 | 98,243 | 241,682 | 470,451 | 31,977 | 0 | 1,058,076 |
| Total | $ 192,238 | $ 26,492 | $ 98,340 | $ 246,754 | $ 472,455 | $ 32,153 | $ 0 | $ 1,068,432 |

*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 $10.3 million and $10.4 million at June 30, 2018 and December 31, 2017, respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings (TDRs).

The net carrying value of impaired loans is based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At June 30, 2018 and December 31, 2017, $4.2 million and $4.0 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, 2018, $1.3 million of the Company’s allowance for loan losses was allocated to impaired loans totaling $10.3 million compared to $1.3 million of the Company's allowance for loan losses allocated to impaired loans totaling approximately $10.4 million at December 31, 2017. Management determined that $3.3 million, or 33%, of total impaired loans required no reserve allocation at June 30, 2018 compared to $2.4 million, or 23%, at December 31, 2017 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, 2018 and December 31, 2017 are as follows:

| **(in thousands)** | June 30, 2018 | December 31, 2017 |
|---|---|---|
| Non-accrual loans | $ 6,311 | $ 5,672 |
| Performing TDRs | 3,940 | 4,684 |
| Total impaired loans | $ 10,251 | $ 10,356 |

The following tables provide additional information about impaired loans at June 30, 2018 and December 31, 2017, 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, 2018 | | | |
| With no related allowance recorded: | | | |
| Commercial, financial and agricultural | $ 1,282 | $ 1,351 | $ 0 |
| Real estate - construction residential | 0 | 0 | 0 |
| Real estate - construction commercial | 169 | 188 | 0 |
| Real estate - residential | 993 | 1,048 | 0 |
| Real estate - commercial | 753 | 753 | 0 |
| Consumer | 137 | 137 | 0 |
| Total | $ 3,334 | $ 3,477 | $ 0 |
| With an allowance recorded: | | | |
| Commercial, financial and agricultural | $ 1,605 | $ 1,927 | $ 410 |
| Real estate - construction residential | 0 | 0 | 0 |
| Real estate - residential | 4,193 | 4,287 | 668 |

| | | | |
|---|---|---|---|
| Real estate - commercial | 952 | 1,078 | 185 |
| Installment and other consumer | 167 | 189 | 19 |
| Total | $ 6,917 | $ 7,481 | $ 1,282 |
| Total impaired loans | $ 10,251 | $ 10,958 | $ 1,282 |

| (in thousands) | Recorded Investment | Unpaid Principal Balance | Specific Reserves |
|---|---|---|---|
| December 31, 2017 | | | |
| With no related allowance recorded: | | | |
| Commercial, financial and agricultural | $ 1,393 | $ 1,445 | $ 0 |
| Real estate - residential | 674 | 688 | 0 |
| Real estate - commercial | 366 | 395 | 0 |
| Total | $ 2,433 | $ 2,528 | $ 0 |
| With an allowance recorded: | | | |
| Commercial, financial and agricultural | $ 1,614 | $ 1,834 | $ 500 |
| Real estate - construction commercial | 97 | 97 | 48 |
| Real estate - residential | 4,398 | 4,500 | 521 |
| Real estate - commercial | 1,638 | 1,743 | 243 |
| Consumer | 176 | 196 | 21 |
| Total | $ 7,923 | $ 8,370 | $ 1,333 |
| Total impaired loans | $ 10,356 | $ 10,898 | $ 1,333 |

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2018 | | 2017 | | 2018 | | 2017 | |
| **(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 | $1,153 | $ 0 | $464 | $ -1 | $1,302 | $ 1 | $519 | $ 0 |
| Real estate - construction commercial | 113 | 0 | 0 | 0 | 42 | 0 | 0 | 0 |
| Real estate - residential | 933 | 3 | 852 | 3 | 900 | 6 | 912 | 7 |
| Real estate - commercial | 116 | 10 | 395 | -2 | 237 | 19 | 500 | 0 |
| Installment and other consumer | 137 | 0 | 2 | 0 | 34 | 0 | 31 | 0 |
| Total | $2,452 | $ 13 | $1,713 | $ 0 | $2,515 | $ 26 | $1,962 | $ 7 |
| With an allowance recorded: | | | | | | | | |
| Commercial, financial and agricultural | $1,621 | $ 8 | $1,214 | $ 8 | $1,737 | $ 15 | $1,199 | $ 19 |
| Real estate - construction residential | 20 | 0 | 0 | 0 | 15 | 0 | 0 | 0 |
| Real estate - construction commercial | 0 | 0 | 48 | 0 | 24 | 0 | 49 | 0 |
| Real estate - residential | 4,118 | 14 | 4,790 | 42 | 4,247 | 47 | 4,595 | 87 |
| Real estate - commercial | 1,732 | 5 | 1,604 | 14 | 1,691 | 10 | 1,505 | 29 |
| | 172 | 1 | 51 | 0 | 167 | 1 | 48 | 0 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Installment and other consumer | | | | | | | | |
| Total | $7,663 | $ 28 | $7,707 | $ 64 | $7,881 | $ 73 | $7,396 | $ 135 |
| Total impaired loans | $10,115 | $ 41 | $9,420 | $ 64 | $10,396 | $ 99 | $9,358 | $ 142 |

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 $41,000 and $99,000, for the three months and six months ended June 30, 2018, respectively compared to $64,000 and $142,000 for the three and six months ended June 30, 2017, 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 collectability 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 collectability of interest and principal is probable and the borrower demonstrates the ability to pay under the terms of the note through a sustained period of repayment performance, which is generally six months.

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

The following table provides aging information for the Company's past due and non-accrual loans at June 30, 2018 and December 31, 2017.

| **(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, 2018 | | | | | |
| Commercial, Financial, and Agricultural | $197,928 | $ 271 | $ 0 | $ 2,429 | $200,628 |
| Real Estate Construction - Residential | 28,285 | 0 | 0 | 0 | 28,285 |
| Real Estate Construction - Commercial | 106,237 | 0 | 0 | 169 | 106,406 |
| Real Estate Mortgage - Residential | 242,937 | 695 | 8 | 2,775 | 246,415 |
| Real Estate Mortgage - Commercial | 478,383 | 535 | 0 | 653 | 479,571 |
| Installment and Other Consumer | 32,363 | 208 | 34 | 285 | 32,890 |
| Total | $1,086,133 | $ 1,709 | $ 42 | $ 6,311 | $1,094,195 |
| December 31, 2017 | | | | | |
| Commercial, Financial, and Agricultural | $189,537 | $ 192 | $ 2 | $ 2,507 | $192,238 |
| Real Estate Construction - Residential | 25,930 | 287 | 275 | 0 | 26,492 |
| Real Estate Construction - Commercial | 98,243 | 0 | 0 | 97 | 98,340 |
| Real Estate Mortgage - Residential | 242,597 | 2,173 | 28 | 1,956 | 246,754 |
| Real Estate Mortgage - Commercial | 471,476 | 43 | 0 | 936 | 472,455 |
| Installment and Other Consumer | 31,715 | 239 | 23 | 176 | 32,153 |
| Total | $1,059,498 | $ 2,934 | $ 328 | $ 5,672 | $1,068,432 |

*Credit Quality*

The Company categorizes loans into risk categories based upon an internal rating system reflecting management's risk assessment. Loans are placed on *watch* status when one or more weaknesses that may result in the deterioration of the

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

Hawthorn Bancshares, Inc.

and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

The following table presents the risk categories by class at June 30, 2018 and December 31, 2017.

| (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, 2018 | | | | | | | |
| Watch | $ 7,378 | $ 598 | $ 3,581 | $ 8,584 | $ 33,482 | $ 9 | $53,632 |
| Substandard | 94 | 0 | 0 | 1,371 | 718 | 6 | 2,189 |
| Performing TDRs | 458 | 0 | 0 | 2,410 | 1,053 | 19 | 3,940 |
| Non-accrual | 2,429 | 0 | 169 | 2,775 | 653 | 285 | 6,311 |
| Total | $ 10,359 | $ 598 | $ 3,750 | $ 15,140 | $ 35,906 | $ 319 | $66,072 |
| At December 31, 2017 | | | | | | | |
| Watch | $ 9,868 | $ 1,459 | $ 1,284 | $ 9,978 | $ 49,197 | $ 0 | $71,786 |
| Substandard | 658 | 462 | 0 | 2,262 | 723 | 16 | 4,121 |
| Performing TDRs | 500 | 0 | 0 | 3,116 | 1,068 | 0 | 4,684 |
| Non-accrual | 2,507 | 0 | 97 | 1,956 | 936 | 176 | 5,672 |
| Total | $ 13,533 | $ 1,921 | $ 1,381 | $ 17,312 | $ 51,924 | $ 192 | $86,263 |

*Troubled Debt Restructurings*

At June 30, 2018, loans classified as TDRs totaled $5.9 million, of which $2.0 million were classified as nonperforming TDRs and included in non-accrual loans and $3.9 million were classified as performing TDRs. At December 31, 2017, loans classified as TDRs totaled $6.4 million, of which $1.7 million were classified as nonperforming TDRs and included in non-accrual loans and $4.7 million were classified as performing TDRs. Both performing and nonperforming TDRs are considered impaired loans. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan's

effective interest rate or the fair value of the underlying collateral less applicable selling costs. Accordingly, specific reserves of $510,000 and $577,000 related to TDRs were allocated to the allowance for loan losses at June 30, 2018 and December 31, 2017, respectively.

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

| | Six Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2018 | | | 2017 | | |
| | 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 | 1 | $ 131 | $ 130 |
| Real estate mortgage - residential | 1 | 75 | 75 | 0 | 0 | 0 |
| Real estate mortgage - commercial | 1 | 68 | 64 | 1 | 56 | 52 |
| Consumer | 4 | 48 | 47 | 0 | 0 | 0 |
| Total | 6 | $ 191 | $ 186 | 2 | $ 187 | $ 182 |

(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 six loans meeting the TDR criteria that were modified during the three and six months ended June 30, 2018, respectively, compared to no loans and two loans during the three and six months ended June 30, 2017, respectively.

The Company considers a TDR to be in default when it is 90 days or more past due under the modified terms, a charge-off occurs, or it is the process of foreclosure. There were no loans modified as a TDR that defaulted during any of the three and six months ended June 30, 2018 and 2017, respectively, and within twelve months of their modification date. During 2018, one real estate mortgage loan went to foreclosure totaling $48,000 and one commercial real estate loan totaling $366,000 was sold at foreclosure. See *Lending and Credit Management* section for further information.

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

(3) Other Real Estate and Repossessed Assets

| | June 30, | December 31, |
|---|---|---|
| **(in thousands)** | 2018 | 2017 |
| Commercial | $727 | $ 727 |
| Real estate construction - residential | 179 | 0 |
| Real estate construction - commercial | 12,101 | 12,380 |
| Real estate mortgage - residential | 317 | 382 |
| Real estate mortgage - commercial | 2,934 | 2,909 |
| Repossessed assets | 0 | 5 |
| Total | $16,258 | $ 16,403 |
| Less valuation allowance for other real estate owned | (3,022 ) | (3,221 ) |
| Total other real estate and repossessed assets | $13,236 | $ 13,182 |

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, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Balance at beginning of period | $ 16,264 | $ 16,669 | $ 16,403 | $ 17,291 |
| Additions | 104 | 52 | 382 | 155 |
| Proceeds from sales | (80 ) | (126 ) | (304 ) | (784 ) |
| Charge-offs against the valuation allowance for other real estate owned, net | (30 ) | (53 ) | (225 ) | (170 ) |
| Net gain on sales | 0 | (12 ) | 2 | 38 |
| Total other real estate and repossessed assets | $ 16,258 | $ 16,530 | $ 16,258 | $ 16,530 |
| Less valuation allowance for other real estate owned | (3,022 ) | (3,174 ) | (3,022 ) | (3,174 ) |

| | | | | |
|---|---|---|---|---|
| Balance at end of period | $ 13,236 | $ 13,356 | $ 13,236 | $ 13,356 |

At June 30, 2018, $246,000 of consumer mortgage loans secured by residential real estate properties were in the process of foreclosure compared to no loans at December 31, 2017.

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)** | **2018** | **2017** | **2018** | **2017** |
| Balance, beginning of period | $ 3,025 | $ 3,044 | $ 3,221 | $ 3,129 |
| Provision for other real estate owned | 27 | 183 | 26 | 215 |
| Charge-offs | (30) | (53) | (225) | (170) |
| Balance, end of period | $ 3,022 | $ 3,174 | $ 3,022 | $ 3,174 |

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

(4) Investment Securities

The amortized cost and fair value of debt securities classified as available-for-sale at June 30, 2018 and December 31, 2017 were as follows:

| | Total Amortized | Gross Unrealized | | Fair |
|---|---|---|---|---|
| ***(in thousands)*** | **Cost** | **Gains** | **Losses** | **Value** |
| June 30, 2018 | | | | |
| U.S. Treasury | $ 1,983 | $ 0 | $ (53 ) | $ 1,930 |
| U.S. government and federal agency obligations | 11,443 | 0 | (351 ) | 11,092 |
| Government sponsored enterprises | 46,773 | 4 | (718 ) | 46,059 |
| Obligations of states and political subdivisions | 42,054 | 38 | (633 ) | 41,459 |
| Mortgage-backed securities: | | | | |
| Residential - government agencies | 131,243 | 35 | (4,217 ) | 127,061 |
| Total available-for-sale securities | $ 233,496 | $ 77 | $ (5,972 ) | $ 227,601 |
| | | | | |
| December 31, 2017 | | | | |
| U.S. Treasury | $ 1,980 | $ 0 | $ (13 ) | $ 1,967 |
| U.S. government and federal agency obligations | 12,341 | 0 | (268 ) | 12,073 |
| Government sponsored enterprises | 37,321 | 0 | (424 ) | 36,897 |
| Obligations of states and political subdivisions | 47,019 | 114 | (477 ) | 46,656 |
| Mortgage-backed securities: | | | | |
| Residential - government agencies | 131,045 | 44 | (2,140 ) | 128,949 |
| Total available-for-sale securities | $ 229,706 | $ 158 | $ (3,322 ) | $ 226,542 |

All of the Company’s investment securities are classified as available for sale. Agency bonds and notes, small business administration guaranteed loan certificates (SBA), residential and commercial agency mortgage-backed securities, and

agency collateralized mortgage obligations (CMO) include securities issued by the Government National Mortgage Association (GNMA), a U.S. government agency, and the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal Home Loan Bank (FHLB), which are U.S. government-sponsored enterprises.

Other Investments and securities primarily consist of Federal Home Loan Bank stock, subordinated debt equity securities, and the Company's interest in statutory trusts. These securities are reported at cost in the amount of $9.3 million and $11.0 million as of June 30, 2018 and December 31, 2017, respectively.

Debt securities with carrying values aggregating approximately $187.3 million and $181.7 million at June 30, 2018 and December 31, 2017, 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, 2018, 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 | $ 12,173 | $ 12,120 |
| Due after one year through five years | 68,835 | 68,187 |
| Due after five years through ten years | 18,243 | 17,287 |
| Due after ten years | 3,002 | 2,946 |
| Total | 102,253 | 100,540 |
| Mortgage-backed securities | 131,243 | 127,061 |
| Total available-for-sale securities | $ 233,496 | $ 227,601 |

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(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, 2018 and December 31, 2017 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, 2018 | | | | | | |
| U.S. Treasury | $1,930 | $(53) | $0 | $0 | $1,930 | $(53) |
| U.S. government and federal agency obligations | 0 | 0 | 11,092 | (351) | 11,092 | (351) |
| Government sponsored enterprises | 17,776 | (260) | 25,333 | (458) | 43,109 | (718) |
| Obligations of states and political subdivisions | 22,974 | (228) | 12,371 | (405) | 35,345 | (633) |
| Mortgage-backed securities: | | | | | | |
| Residential - government agencies | 55,223 | (1,367) | 65,303 | (2,850) | 120,526 | (4,217) |
| Total | $97,903 | $(1,908) | $114,099 | $(4,064) | $212,002 | $(5,972) |
| | | | | | | |
| **(in thousands)** | | | | | | |
| At December 31, 2017 | | | | | | |
| U.S. Treasury | $1,967 | $(13) | $0 | $0 | $1,967 | $(13) |
| U.S. government and federal agency obligations | 0 | 0 | 12,073 | (268) | 12,073 | (268) |
| Government sponsored enterprises | 16,471 | (119) | 20,426 | (305) | 36,897 | (424) |
| Obligations of states and political subdivisions | 22,013 | (165) | 12,570 | (312) | 34,583 | (477) |
| Mortgage-backed securities: | | | | | | |
| Residential - government agencies | 52,829 | (488) | 69,580 | (1,652) | 122,409 | (2,140) |
| Total | $93,280 | $(785) | $114,649 | $(2,537) | $207,929 | $(3,322) |

The total available for sale portfolio consisted of approximately 369 securities at June 30, 2018. The portfolio included 322 securities having an aggregate fair value of $212.0 million that were in a loss position at June 30, 2018.

Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled $114.1 million at fair value. The $6.0 million aggregate unrealized loss included in accumulated other comprehensive income at June 30, 2018 was caused by interest rate fluctuations.

The total available for sale portfolio consisted of approximately 355 securities at December 31, 2017. The portfolio included 280 securities having an aggregate fair value of $207.9 million that were in a loss position at December 31, 2017. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer had a fair value of $114.6 million at December 31, 2017. The $3.3 million aggregate unrealized loss included in accumulated other comprehensive loss at December 31, 2017 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, 2018 and December 31, 2017, respectively. In the absence 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)** | **2018** | **2017** | **2018** | **2017** |
| Gains realized on sales | $108 | $ 0 | $206 | $ 0 |
| Losses realized on sales | 0 | 0 | 0 | 0 |
| Other-than-temporary impairment recognized | 0 | 0 | 0 | 0 |
| Investment securities gains | $108 | $ 0 | $206 | $ 0 |

18

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

## (5) Intangible Assets

*Mortgage Servicing Rights*

At June 30, 2018, the Company was servicing approximately $284.9 million of loans sold to the secondary market compared to $285.8 million at December 31, 2017, and $289.8 million at June 30, 2017. Mortgage loan servicing fees, reported as non-interest income, earned on loans sold were $210,000 and $413,000 for the three and six months ended June 30, 2018, respectively, compared to $211,000 and $420,000 for the three and six months ended June 30, 2017, 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)** | **2018** | **2017** | **2018** | **2017** |
| Balance at beginning of period | $ 2,781 | $ 2,877 | $ 2,713 | $ 2,584 |
| Originated mortgage servicing rights | 81 | 66 | 131 | 115 |
| Changes in fair value: | | | | |
| Due to change in model inputs and assumptions (1) | 30 | (56) | 133 | 319 |
| Other changes in fair value (2) | (79) | (121) | (164) | (252) |
| Balance at end of period | $ 2,813 | $ 2,766 | $ 2,813 | $ 2,766 |

(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 June 30, 2018 and 2017, respectively:

| | Six Months Ended June 30, | |
|---|---|---|
| | 2018 | 2017 |
| Weighted average constant prepayment rate | 9.55 % | 9.28 % |
| Weighted average note rate | 3.90 % | 3.86 % |
| Weighted average discount rate | 10.34 % | 9.75 % |
| Weighted average expected life (in years) | 6.10 | 6.10 |

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

| | June 30, | December 31, |
|---|---|---|
| | 2018 | 2017 |
| Federal funds purchased | $ 0 | $ 0 |
| Repurchase agreements | 36,103 | 27,560 |
| Total | $ 36,103 | $ 27,560 |

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

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

| 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, 2018 | | | | |
| U.S. Treasury | $1,445 | $ 0 | $ 0 | $1,445 |
| Government sponsored enterprises | 14,205 | 0 | 0 | 14,205 |
| Asset-backed securities | 20,453 | 0 | 0 | 20,453 |
| Total | $36,103 | $ 0 | $ 0 | $36,103 |
| At December 31, 2017 | | | | |
| U.S. Treasury | $1,964 | $ 0 | $ 0 | $1,964 |
| U.S. government and federal agency obligations | 2,977 | 0 | 0 | 2,977 |
| Government sponsored enterprises | 8,382 | 0 | 0 | 8,382 |
| Asset-backed securities | 14,237 | 0 | 0 | 14,237 |
| Total | $27,560 | $ 0 | $ 0 | $27,560 |

(7) Income Taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 7.2% and 11.3% for the three and six months ended June 30, 2018, respectively, compared to 33.9% and 34.1% for the three and six months ended June 30, 2017, respectively. As further described below, the decrease in tax rate for the comparative periods is primarily due to a decrease in the federal corporate tax rate, the release of the valuation allowance related to capital losses as a result of the Company’s tax planning initiatives, a pension contribution made during the second quarter of 2018 that was attributable to the 2017 plan year, and the Company’s additional tax planning initiatives.

The federal corporate income tax rate declined from 34% to 21% effective January 1, 2018 as a result of the Tax Cuts and Jobs Act. The Company's tax rate is lower than the federal statutory rate primarily as a result of tax-exempt income, the release of the valuation allowance related to capital loss carryforwards, and a pension contribution made during the second quarter of 2018 that was attributable to the 2017 plan year. The provisional adjustments recorded in the fourth quarter of 2017 related to the enactment of the Tax Cuts and Jobs Act have not been finalized as of June 30, 2018. The Company expects to finalize those adjustments within the one-year measurement period provided under Staff Accounting Bulletin No. 118 in regards to the application of FASB's ASC Topic 740, *Income Taxes*. The impact of the Tax Cuts and Jobs Act is expected to require further adjustments in 2018 due to anticipated additional guidance from the U.S. Department of the Treasury, changes in our assumptions, completion of 2017 U.S. tax returns and further information and interpretations that become available.

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, and tax planning initiatives in making this assessment. In management's opinion, the Company will more likely than not realize the benefits of its deferred tax assets and, therefore, has not established a valuation allowance against its deferred tax assets as of June 30, 2018. Management arrived at this conclusion based upon the level of historical taxable income and projections for future taxable income of the appropriate character over the periods in which the deferred tax assets are deductible. As indicated above, the Company released a $46,000 valuation allowance against certain capital loss carryforwards during the second quarter of 2018 as a result of the execution of certain tax planning initiatives that generated sufficient capital gain income prior to the expiration of the carryforwards.

The Company follows ASC Topic 740, *Income Taxes,* which addresses the accounting for uncertain tax positions. For each of the three and six months ended June 30, 2018 and 2017, respectively, the Company did not have any uncertain tax provisions, and did not record any related tax liabilities.

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

(8) Stockholders' Equity

*Accumulated Other Comprehensive Loss*

The following details the change in the components of the Company's accumulated other comprehensive loss for the six months ended June 30, 2018 and 2017:

| | Six months ended June 30, 2018 | | |
|---|---|---|---|
| **(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 | $ (2,500 ) | $ (3,162 ) | $ (5,662 ) |
| Other comprehensive (loss) income, before reclassifications | (2,730 ) | 108 | (2,622 ) |
| Amounts reclassified from accumulated other comprehensive (loss) income | 0 | 0 | 0 |
| Current period other comprehensive (loss) income, before tax | (2,730 ) | 108 | (2,622 ) |
| Income tax expense (benefit) | 573 | (23 ) | 550 |
| Current period other comprehensive (loss) income, net of tax | (2,157 ) | 85 | (2,072 ) |
| Balance at end of period | $ (4,657 ) | $ (3,077 ) | $ (7,734 ) |

| | Six months ended June 30, 2017 | | |
|---|---|---|---|
| | | Unrecognized Net | Accumulated |

| **(in thousands)** | Unrealized Gain (Loss) **on Securities (1)** | Pension and Postretirement **Costs (2)** | Other Comprehensive **Loss** |
|---|---|---|---|
| Balance at beginning of period | $ (1,936 ) | $ (1,865 ) | $ (3,801 ) |
| Other comprehensive income, before reclassifications | 1,452 | 45 | 1,497 |
| Amounts reclassified from accumulated other comprehensive income (loss) | 0 | 0 | 0 |
| Current period other comprehensive income, before tax | 1,452 | 45 | 1,497 |
| Income tax expense | (552 ) | (18 ) | (570 ) |
| Current period other comprehensive income, net of tax | 900 | 27 | 927 |
| Balance at end of period | $ (1,036 ) | $ (1,838 ) | $ (2,874 ) |

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

## (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)** | **2018** | **2017** | **2018** | **2017** |
| Payroll taxes | $ 301 | $ 288 | $ 652 | $ 644 |
| Medical plans | 612 | 468 | 1,160 | 894 |
| 401k match and profit sharing | 237 | 226 | 423 | 476 |
| Periodic pension cost | 405 | 335 | 810 | 671 |
| Other | 10 | 9 | 25 | 25 |
| Total employee benefits | $ 1,565 | $ 1,326 | $ 3,070 | $ 2,710 |

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.

21

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

*Pension*

The Company provides a noncontributory defined benefit pension plan for all full-time employees. Beginning January 1, 2018 and for all retrospective periods presented, the Company adopted the guidance under ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. Under the new guidance only the service cost component of the net periodic benefit cost is reported in the same income statement line item as salaries and benefits, and the remaining components are reported as other non-interest expense. 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. The Company made a pension contribution in the amount of $1.8 million in the second quarter of 2018. The 2018 minimum required contribution is $1.0 million. Effective July 1, 2017, the Company amended the pension plan to effectuate a "soft freeze" such that no individual hired (or rehired in the case of a former employee) by the Company after September 30, 2017, whether or not such individual is or was a vested member in the plan, will be eligible to be an active member and be entitled to accrue any benefits under the plan. Certain individuals hired by the Company before July 1, 2017 are also not eligible to participate in the plan.

*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:

| | Pension Benefits | |
|---|---|---|
| (in thousands) | 2018 | 2017 |

| | | |
|---|---|---|
| Service cost - benefits earned during the year | $1,620 | $1,343 |
| Interest costs on projected benefit obligations (a) | 1,033 | 1,009 |
| Expected return on plan assets (a) | (1,267) | (1,124) |
| Expected administrative expenses (a) | 93 | 88 |
| Amortization of prior service cost (a) | 79 | 79 |
| Amortization of unrecognized net loss (a) | 138 | 11 |
| Net periodic pension cost | $1,696 | $1,406 |
| | | |
| Net periodic pension cost for the three months ended June 30, (actual) | $405 | $335 |
| Net periodic pension cost for the six months ended June 30, (actual) | $810 | $671 |

(a) The components of net periodic pension cost other than the service cost component are included in other non-interest expense.

(10) Stock Compensation

The Company has one equity compensation plan for its employees pursuant to which options were granted.

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 | 20,909 | $ 14.20 | | |
| Granted | 0 | 0.00 | | |
| Exercised | 0 | 0.00 | | |
| Forfeited or expired | 0 | 0.00 | | |
| Outstanding, June 30, 2018 | 20,909 | $ 14.20 | 0.23 | $160,975 |
| Exercisable, June 30, 2018 | 20,909 | $ 14.20 | 0.23 | $160,975 |

Options have been adjusted to reflect a 4% stock dividend paid on July 1, 2018.

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

Total stock-based compensation expense was $0 for the three and six months ended June 30, 2018 compared to $1,000 and $2,000 for the three and six months ended June 30, 2017, respectively. As of December 31, 2017, there was no remaining unrecognized compensation expense related to non-vested stock awards. The Plan expired on February 28, 2010, except as to outstanding options under the Plan, and no further options may be granted pursuant to the Plan.

(11) Earnings per Share

***Stock Dividend*** On July 1, 2018, the Company paid a special stock dividend of 4% to common shareholders of record at the close of business on June 15, 2018. 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.

Presented below is a summary of the components used to calculate basic and diluted earnings per common share, which have been restated for all stock dividends:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(dollars in thousands, except per share data)** | **2018** | **2017** | **2018** | **2017** |
| Basic earnings per share: | | | | |
| Net income available to shareholders | $ 2,907 | $ 1,919 | $ 4,997 | $ 4,020 |
| Average shares outstanding | 6,021,038 | 6,070,080 | 6,024,851 | 6,070,749 |

| | | | | |
|---|---|---|---|---|
| Basic earnings per share | $ 0.48 | $ 0.32 | $ 0.83 | $ 0.66 |
| | | | | |
| Diluted earnings per share: | | | | |
| Net income available to shareholders | $ 2,907 | $ 1,919 | $ 4,997 | $ 4,020 |
| Average shares outstanding | 6,021,038 | 6,070,080 | 6,024,851 | 6,070,749 |
| Effect of dilutive stock options | 6,883 | 5,141 | 6,442 | 5,157 |
| Average shares outstanding including dilutive stock options | 6,027,921 | 6,075,221 | 6,031,293 | 6,075,906 |
| Diluted earnings per share | $ 0.48 | 0.32 | $ 0.83 | 0.66 |

Under the treasury stock method, outstanding stock options are dilutive when the average market price of the Company’s common stock, when combined with the effect of any unamortized compensation expense, exceeds the option price during the period, except when the Company has a loss from continuing operations available to shareholders. In addition, proceeds from the assumed exercise of dilutive options along with the related tax benefit are assumed to be used to repurchase common shares at the average market price of such stock during the period. There were no outstanding stock options for any of the three and six months ended June 30, 2018 and 2017, respectively, that were omitted from the computation of diluted earnings per share as a result of being considered anti-dilutive.

***Repurchase Program*** On August 6, 2015, the Board of Directors authorized a share repurchase plan (the plan) to purchase through open market transactions up to $2.0 million market value of the Company’s common stock. On August 8, 2017, the Board authorized the repurchase of an additional $1.5 million market value of the Company’s common stock. As of June 30, 2018, the Company had repurchased a total of 95,709 shares of common stock pursuant to the plan at an average price of $17.90 per share, including 8,668 shares of common stock repurchased pursuant to the plan during the six months ended June 30, 2018 at an average price of $20.63 per share. At June 30, 2018, approximately $1.8 million remained available for the purchase of shares under the plan. The current plan expires September 8, 2018 unless renewed.

## (12) Fair Value Measurements

Fair value represents the amount expected to be received to sell an asset or paid to transfer a liability in its principal or most advantageous market in an orderly transaction between market participants at the measurement date.

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

Depending on the nature of the asset or liability, the Company uses various valuation methodologies and assumptions to estimate fair value. The measurement of fair value under US GAAP uses a hierarchy intended to maximize the use of observable inputs and minimize the use of unobservable inputs. This hierarchy uses three levels of inputs to measure the fair value of assets and liabilities as follows. As of June 30, 2018 and December 31, 2017, 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. A quoted price in an active market provides the most reliable evidence of fair value and is used to measure fair value whenever available. A contractually binding sales price also provides reliable evidence of fair value.

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

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

In accordance with fair value accounting guidance, the Company measures, records, and reports various types of assets and liabilities at fair value on either a recurring or non-recurring basis in the Consolidated Financial Statements. 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 Assets and Labilities Measured at Fair Value on a Recurring Basis***

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

***Available-for-Sale Securities***

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

***Mortgage Servicing Rights***

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

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

| | Fair Value Measurements | | | |
|---|---|---|---|---|
| **(in thousands)** | **Fair Value** | Quoted Prices in Active Markets for Identical Assets **(Level 1)** | Other Observable Inputs **(Level 2)** | Significant Unobservable Inputs **(Level 3)** |
| June 30, 2018 | | | | |
| Assets: | | | | |
| U.S. Treasury | $1,930 | $1,930 | 0 | $ 0 |
| U.S. government and federal agency obligations | 11,092 | 0 | 11,092 | 0 |
| Government sponsored enterprises | 46,059 | 0 | 46,059 | 0 |
| Obligations of states and political subdivisions | 41,459 | 0 | 41,459 | 0 |
| Mortgage-backed securities | 127,061 | 0 | 127,061 | 0 |
| Mortgage servicing rights | 2,813 | 0 | 0 | 2,813 |
| Total | $230,414 | $1,930 | $225,671 | $ 2,813 |
| | | | | |
| December 31, 2017 | | | | |
| Assets: | | | | |
| U.S. Treasury | $1,967 | $1,967 | 0 | $ 0 |
| U.S. government and federal agency obligations | 12,073 | 0 | 12,073 | 0 |
| Government sponsored enterprises | 36,897 | 0 | 36,897 | 0 |
| Obligations of states and political subdivisions | 46,656 | 0 | 46,656 | 0 |
| Mortgage-backed securities | 128,949 | 0 | 128,949 | 0 |
| Mortgage servicing rights | 2,713 | 0 | 0 | 2,713 |
| Total | $229,255 | $1,967 | $224,575 | $ 2,713 |

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

| (in thousands) | Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Mortgage Servicing Rights **Three Months Ended June 30,** | | Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Mortgage Servicing Rights **Six Months Ended June 30,** | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Balance at beginning of period | $ 2,781 | $ 2,877 | $ 2,713 | $ 2,584 |
| Total gains or losses (realized/unrealized): | | | | |
| Included in earnings | (49) | (177) | (31) | 67 |
| Included in other comprehensive income | 0 | 0 | 0 | 0 |
| Purchases | 0 | 0 | 0 | 0 |
| Sales | 0 | 0 | 0 | 0 |
| Issues | 81 | 66 | 131 | 115 |
| Settlements | 0 | 0 | 0 | 0 |
| Balance at end of period | $ 2,813 | $ 2,766 | $ 2,813 | $ 2,766 |

The change in valuation of mortgage servicing rights arising from inputs and assumptions increased $30,000 and $133,000 for the three and six months ended June 30, 2018, respectively, compared to a decrease of $56,000 and an increase of $319,000 for the three and six months ended June 30, 2017, respectively.

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

***Valuation methods for Assets and Liabilities measured at fair value on a nonrecurring basis***

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

*Collateral dependent impaired loans*

While the overall loan portfolio is not carried at fair value, the Company periodically records nonrecurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Nonrecurring adjustments also include certain impairment amounts for collateral dependent loans when establishing the allowance for loan losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan. In determining the value of real estate collateral, the Company relies on external and internal appraisals of property values depending on the size and complexity of the real estate collateral. The Company maintains staff that is trained to perform in-house evaluations and also review third party appraisal reports for reasonableness. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgments based on the experience and expertise of internal specialists. Values of all loan collateral are regularly reviewed by senior loan committee. Because many of these inputs are not observable, the measurements are classified as Level 3. As of June 30, 2018, the Company identified $4.2 million in collateral dependent impaired loans that had specific allowances for losses aggregating $911,000. Related to these loans, there was $192,000 and $250,000 in charge-offs recorded during the three and six months ended June 30, 2018, respectively. As of June 30, 2017, the Company identified $3.0 million in collateral dependent impaired loans that had specific allowances for losses aggregating $755,000. Related to these loans, there was $63,000 and $83,000 in charge-offs recorded during the three and six months ended June 30, 2017, respectively.

*Other Real Estate and Foreclosed Assets*

Other real estate owned (OREO) and foreclosed assets consisted of loan collateral that has been repossessed through foreclosure. This collateral is comprised of commercial and residential real estate and other non-real estate property, including autos, manufactured homes, and construction equipment. Subsequent to foreclosure, these assets initially are carried at fair value of the collateral less estimated selling costs. Fair value, when recorded, is generally based upon appraisals by approved, independent state certified appraisers. Like impaired loans, appraisals on OREO may be discounted based on the Company's historical knowledge, changes in market conditions from the time of appraisal or other information available. During the holding period, 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.

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

| | **Fair Value Measurements Using** | | | | | |
|---|---|---|---|---|---|---|
| **(in thousands)** | Total **Fair Value** | Quoted Prices in Active Markets for Identical Assets **(Level 1)** | Other Observable Inputs **(Level 2)** | Significant Unobservable Inputs **(Level 3)** | Three Months Ended June 30, Total Gains **(Losses)*** | Six Months Ended June 30, Total Gains **(Losses)*** |
| June 30, 2018 | | | | | | |
| Assets: | | | | | | |
| Collateral dependent impaired loans: | | | | | | |
| Commercial, financial, & agricultural | $1,648 | $ 0 | $ 0 | $ 1,648 | $ (166) | $ (166) |
| Real estate construction - commercial | 169 | 0 | 0 | 169 | 0 | (27) |
| Real estate mortgage - residential | 998 | 0 | 0 | 998 | (12) | (12) |
| Real estate mortgage - commercial | 337 | 0 | 0 | 337 | 0 | (20) |
| Consumer | 137 | 0 | 0 | 137 | (14) | (25) |
| Total | $3,289 | $ 0 | $ 0 | $ 3,289 | $ (192) | $ (250) |
| Other real estate and foreclosed assets | $13,236 | $ 0 | $ 0 | $ 13,236 | $ (27) | $ (26) |
| June 30, 2017 | | | | | | |
| Assets: | | | | | | |
| Collateral dependent impaired loans: | | | | | | |
| Commercial, financial, & agricultural | $523 | $ 0 | $ 0 | $ 523 | $ 0 | $ (1) |
| Real estate mortgage - residential | 1,488 | 0 | 0 | 1,488 | (62) | (65) |
| Real estate mortgage - commercial | 220 | 0 | 0 | 220 | 0 | (4) |
| Consumer | 0 | 0 | 0 | 0 | (1) | (13) |
| Total | $2,231 | $ 0 | $ 0 | $ 2,231 | $ (63) | $ (83) |
| Other real estate and foreclosed assets | $13,356 | $ 0 | $ 0 | $ 13,356 | $ (195) | $ (180) |

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

(13) 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

Fair values are estimated for portfolios with similar financial characteristics. Loans are segregated by type, such as commercial, real estate, and consumer. Each loan category is further segmented into fixed and variable interest rate categories. The fair value of loans is estimated by using the future value of discounted cash flows using comparable market rates for similar types of loan products and adjusted for market factors. The discount rates used are estimated using comparable market rates for similar types of loan products adjusted to be commensurate with the credit risk, overhead costs, and optionality of such instruments.

Investment Securities

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

Federal 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.

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

Federal Funds Sold, Cash, and Due from Banks

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

Certificates of Deposit in other banks

Certificates of deposit are other investments made by the Company with other financial institutions that are carried at cost.

Mortgage Servicing Rights

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

Cash Surrender Value - Life Insurance

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

Accrued Interest Receivable and Payable

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

Deposits

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

Securities Sold under Agreements to Repurchase

For securities sold under agreements to repurchase, 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.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

A summary of the carrying amounts and fair values of the Company's financial instruments at June 30, 2018 and December 31, 2017 is as follows:

| | June 30, 2018 | | June 30, 2018 Fair Value Measurements | | |
|---|---|---|---|---|---|
| **(in thousands)** | 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)** |
| Assets: | | | | | |
| Cash and due from banks | $15,921 | $15,921 | $15,921 | $0 | $0 |
| Federal funds sold and overnight interest-bearing deposits | 34,863 | 34,863 | 34,863 | 0 | 0 |
| Certificates of deposit in other banks | 10,746 | 10,746 | 10,746 | 0 | 0 |
| Investment in available-for-sale securities | 227,601 | 227,601 | 1,930 | 225,671 | 0 |
| Loans, net | 1,082,983 | 1,061,707 | 0 | 0 | 1,061,707 |
| Investment in FHLB stock | 4,676 | 4,676 | 0 | 4,676 | 0 |
| Mortgage servicing rights | 2,813 | 2,813 | 0 | 0 | 2,813 |
| Cash surrender value - life insurance | 2,516 | 2,516 | 0 | 2,516 | 0 |
| Accrued interest receivable | 5,294 | 5,294 | 5,294 | 0 | 0 |
| | $1,387,413 | $1,366,137 | $68,754 | $232,863 | $1,064,520 |
| Liabilities: | | | | | |
| Deposits: | | | | | |
| Non-interest bearing demand | $250,232 | $250,232 | $250,232 | $0 | $0 |
| Savings, interest checking and money market | 614,976 | 614,976 | 614,976 | 0 | 0 |
| Time deposits | 318,178 | 315,242 | 0 | 0 | 315,242 |
| | 36,103 | 36,103 | 36,103 | 0 | 0 |

| | | | | | |
|---|---|---|---|---|---|
| Federal funds purchased and securities sold under agreements to repurchase | | | | | |
| Federal Home Loan Bank advances and other borrowings | 74,270 | 73,846 | 0 | 73,846 | 0 |
| Subordinated notes | 49,486 | 44,146 | 0 | 44,146 | 0 |
| Accrued interest payable | 790 | 790 | 790 | 0 | 0 |
| | $1,344,035 | $1,335,335 | $902,101 | $ 117,992 | $ 315,242 |

29

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

| | December 31, 2017 | | December 31, 2017 Fair Value Measurements | | |
|---|---|---|---|---|---|
| **(in thousands)** | 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)** |
| Assets: | | | | | |
| Cash and due from banks | $23,325 | $23,325 | $23,325 | $ 0 | $ 0 |
| Federal funds sold and overnight interest-bearing deposits | 39,553 | 39,553 | 39,553 | 0 | 0 |
| Certificates of deposit in other banks | 3,460 | 3,460 | 3,460 | 0 | 0 |
| Investment in available-for-sale securities | 226,542 | 226,542 | 1,967 | 224,575 | 0 |
| Loans, net | 1,057,580 | 1,058,153 | 0 | 0 | 1,058,153 |
| Investment in FHLB stock | 6,390 | 6,390 | 0 | 6,390 | 0 |
| Mortgage servicing rights | 2,713 | 2,713 | 0 | 0 | 2,713 |
| Cash surrender value - life insurance | 2,484 | 2,484 | 0 | 2,484 | 0 |
| Accrued interest receivable | 5,627 | 5,627 | 5,627 | 0 | 0 |
| | $1,367,674 | $1,368,247 | $73,932 | $ 233,449 | $ 1,060,866 |
| Liabilities: | | | | | |
| Deposits: | | | | | |
| Non-interest bearing demand | $245,380 | $245,380 | $245,380 | $ 0 | $ 0 |
| Savings, interest checking and money market | 584,468 | 584,468 | 584,468 | 0 | 0 |
| Time deposits | 295,964 | 294,778 | 0 | 0 | 294,778 |
| Federal funds purchased and securities sold under agreements to repurchase | 27,560 | 27,560 | 27,560 | 0 | 0 |
| Federal Home Loan Bank advances and other borrowings | 121,382 | 121,291 | 0 | 121,291 | 0 |
| Subordinated notes | 49,486 | 39,692 | 0 | 39,692 | 0 |
| Accrued interest payable | 554 | 554 | 554 | 0 | 0 |

| | | | | |
|---|---|---|---|---|
| $ 1,324,794 | $ 1,313,723 | $ 857,962 | $ 160,983 | $ 294,778 |

Off-Balance Sheet Financial Instruments

The fair value of commitments to extend credit and standby letters of credit is 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. The Company believes such commitments have been made on terms that 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 the 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.

(14) Repurchase Reserve Liability

The Company's repurchase reserve liability for estimated losses incurred on sold loans was $160,000 at both June 30, 2018 and December 31, 2017. This liability represents management's estimate of the potential repurchase or make-whole liability for residential mortgage loans originated for sale that may arise from representation and warranty claims that could relate to a variety of issues, including but not limited to, misrepresentation of facts, appraisal issues, or program requirements that may not meet investor guidelines. At June 30, 2018, the Company was servicing 2,726 loans sold to the secondary market with a balance of approximately $284.9 million compared to 2,773 loans sold with a balance of approximately $285.8 million at December 31, 2017, and 2,826 loans sold with a balance of approximately $289.8 million at June 30, 2017.

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(in thousands)** | **2018** | **2017** | **2018** | **2017** |
| Balance at beginning of year | $ 160 | $ 160 | $ 160 | $ 160 |
| Provision for repurchase liability | 0 | 0 | 0 | 0 |
| Reimbursement of expenses | 0 | 0 | 0 | 0 |
| Balance at end of year | $ 160 | $ 160 | $ 160 | $ 160 |

(15) Commitments and Contingencies

The Company issues financial instruments with off-balance-sheet risk in the normal course of business of meeting the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments may involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Company's extent of involvement and maximum potential exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for financial instruments included on its consolidated balance sheets. At June 30, 2018, no amounts have been accrued for any estimated losses for these financial instruments.

The contractual amount of off-balance-sheet financial instruments were as follows as of the dates indicated:

| | June 30, | December 31, |
|---|---|---|
| **(in thousands)** | **2018** | **2017** |
| Commitments to extend credit | $235,159 | $ 238,527 |
| Commitments to originate residential first and second mortgage loans | 2,554 | 1,471 |

| | | |
|---|---|---|
| Standby letters of credit | 77,276 | 74,004 |
| Total | 314,989 | 314,002 |

***Commitments***

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since certain of the commitments and letters of credit are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer’s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management’s credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, furniture and equipment, and real estate.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These standby letters of credit are primarily issued to support contractual obligations of the Company’s customers. The approximate remaining term of standby letters of credit range from one month to five years at June 30, 2018.

*Pending Litigation*

The Company and its subsidiaries are defendants in various legal actions incidental to the Company’s past and current business activities. Based on the 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 the Company’s consolidated financial condition or results of operations in the near term. The Company records a loss accrual for all legal matters for which it deems a loss is probable and can be reasonably estimated. Some legal matters, which are at early stages in the legal process, have not yet progressed to the point where a loss is deemed probable or an amount can be estimated.

Hawthorn Bancshares, Inc.
and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

(16) Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* and all subsequent ASUs that modified Topic 606. As stated in Note 1 *Summary of Significant Accounting Policies*, the implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 605.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, derivatives, and certain credit card fees are also not in the scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as trust department revenue, service charges and fees, debit card income, ATM surcharge income, and sales of other real estate owned. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Noninterest revenue streams within the scope of Topic 606 are discussed below.

*Trust Department Revenue*

Trust and asset management income is primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company’s performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers’ accounts. The Company does not earn performance-based incentives. Optional services such as real estate sales and tax return preparation services are also available to existing trust and asset management customers. The Company’s performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e., as incurred). Payment is received shortly after services are rendered.

*Service Charges on Deposit Accounts*

Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. The Company's performance obligation for account analysis fees and monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Check orders and other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

*Fees, Exchange, and Other Service Charges*

Fees, exchange, and other service charges are primarily comprised of debit and credit card income, ATM fees, merchant services income, and other service charges. Debit and credit card income is primarily comprised of interchange fees earned whenever the Company's debit and credit cards are processed through card payment networks such as Visa. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. Other service charges include revenue from processing wire transfers, bill pay service, cashier's checks, and other services. The Company's performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month.

*Gains/Losses on Sales of Other Real Estate Owned (OREO)*

The Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financing component is present. Two OREO sales for the six months ended June 30, 2018 and two sales for the six months ended June 30, 2017 were financed by the Bank, which financings were consistent with market terms.

**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 the Company, Hawthorn Bancshares, Inc., and its subsidiaries, including, without limitation:

- statements that are not historical in nature, and
- statements preceded by, followed by or that include the words *believes*, *expects, may, will, should, could, anticipates, estimates, intends* or similar expressions.

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

- competitive pressures among financial services companies may increase significantly,
- changes in the interest rate environment may reduce interest margins,
- general economic conditions, either nationally or in Missouri, may be less favorable than expected and may adversely affect the quality of our loans and other assets,
- increases in non-performing assets in the Company's 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 the Company and its acquisition targets may be greater than expected,
- legislative, regulatory or tax law changes may adversely affect the business in which the Company and its subsidiaries are engaged, and
- changes may occur in the securities markets.

We have described under the caption *Risk Factors* in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, and in other reports filed 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 have not been 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***

Crucial to the Company’s community banking strategy is growth in its commercial banking services, retail mortgage lending and retail banking services. Through the branch network of its subsidiary bank, the Company, with $1.5 billion in assets at June 30, 2018, provides a broad range of commercial and personal banking services. The Bank’s specialties include commercial banking for small and mid-sized businesses, including equipment, operating, commercial real estate, Small Business Administration (SBA) loans, and personal banking services including real estate mortgage lending, installment and consumer loans, certificates of deposit, individual retirement and other time deposit accounts, checking accounts, savings accounts, and money market accounts. Other financial services that the Company provides include trust services that include estate planning, investment and asset management services and a comprehensive suite of cash management services. The geographic areas in which the Company provides products and services include the Missouri communities in and surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, Branson, and the greater Kansas City metropolitan area.

The Company's primary source of revenue is net interest income derived primarily from lending and deposit taking activities. Much of the Company's business is commercial, commercial real estate development, and residential mortgage lending. The Company's income from mortgage brokerage activities is directly dependent on mortgage rates and the level of home purchases and refinancing activity.

The success of the Company's growth strategy depends primarily on the ability of its 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. The Company's financial performance also depends, in part, on its 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 the Company's growth strategy depends on its ability to maintain sufficient regulatory capital levels during periods in which general economic conditions are unfavorable and despite economic conditions being beyond its control.

The Company’s 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, the Bank provides trust services.

The deposit accounts of the Bank are insured by the Federal Deposit Insurance Corporation (FDIC) to the extent provided by law. The operations of the Bank are supervised and regulated by the FDIC and the Missouri Division of Finance. Periodic examinations of the 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. The Company is subject to supervision and examination by the Board of Governors of the Federal Reserve System.

**CRITICAL ACCOUNTING POLICIES**

The following accounting policies are considered most critical to the understanding of the 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 the critical accounting policies on the business operations are discussed throughout *Management’s Discussion and Analysis of Financial Condition and Results of Operations*, where such policies affect the reported and expected financial results.

***Allowance for Loan Losses***

Management has identified the accounting policy related to the allowance for loan losses as critical to the understanding of the 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 the Company’s business operations is provided in note 1 to the Company’s unaudited 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 the Company.

34

SELECTED CONSOLIDATED FINANCIAL DATA

The following table presents selected consolidated financial information for the Company as of and for each of the three months ended June 30, 2018 and 2017, respectively. The selected consolidated financial data should be read in conjunction with the unaudited consolidated financial statements of the Company, including the related notes, presented elsewhere herein.

Selected Financial Data

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In thousands, except per share data)** | **2018** | **2017** | **2018** | **2017** |
| Per Share Data | | | | |
| Basic earnings per share | $ 0.48 | $ 0.32 | $ 0.83 | $ 0.66 |
| Diluted earnings per share | 0.48 | 0.32 | 0.83 | 0.66 |
| Dividends paid on common stock | 405 | 338 | 811 | 674 |
| Book value per share | | | 15.46 | 15.67 |
| Market price per share | | | 21.90 | 20.14 |
| Selected Ratios | | | | |
| (Based on average balance sheets) | | | | |
| Return on total assets | 0.80 % | 0.58 % | 0.70 % | 0.61 % |
| Return on stockholders' equity | 12.64 % | 8.10 % | 11.00 % | 8.65 % |
| Stockholders' equity to total assets | 6.33 % | 7.11 % | 6.37 % | 7.06 % |
| Efficiency ratio (1) | 73.49 % | 74.98 % | 75.98 % | 73.75 % |
| (Based on end-of-period data) | | | | |
| Stockholders' equity to assets | | | 6.43 % | 6.88 % |
| Total risk-based capital ratio | | | 13.41 % | 13.47 % |
| Tier 1 risk-based capital ratio | | | 11.13 % | 11.20 % |
| Common equity Tier 1 capital | | | 8.44 % | 8.43 % |
| Tier 1 leverage ratio (2) | | | 9.09 % | 9.77 % |

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

(2) Tier I leverage ratio is calculated by dividing Tier 1 capital by average total consolidated assets.

RESULTS OF OPERATIONS ANALYSIS

The 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, the 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.

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| **(In thousands)** | **2018** | **2017** | **$ Change** | **% Change** | **2018** | **2017** | **$ Change** | **% Change** |
| Net interest income | $11,027 | $10,820 | $ 207 | 1.9 % | $21,782 | $21,307 | $ 475 | 2.2 % |
| Provision for loan losses | 450 | 330 | 120 | 36.4 | 750 | 680 | 70 | 10.3 |
| Noninterest income | 2,486 | 2,099 | 387 | 18.4 | 4,787 | 4,506 | 281 | 6.2 |
| Noninterest expense | 9,931 | 9,687 | 244 | 2.5 | 20,186 | 19,037 | 1,149 | 6.0 |
| Income before income taxes | 3,132 | 2,902 | 230 | 7.9 | 5,633 | 6,096 | (463 ) | (7.6 ) |
| Income tax expense | 225 | 983 | (758 ) | (77.1 ) | 636 | 2,076 | (1,440 ) | (69.4 ) |
| Net income | $2,907 | $1,919 | $ 988 | 51.5 % | $4,997 | $4,020 | $ 977 | 24.3 % |

***Consolidated net income*** of $2.9 million, or $0.48 per diluted share, for the three months ended June 30, 2018 increased $988,000 compared to $1.9 million, or $0.32 per diluted share, for the three months ended June 30, 2017. For the three months ended June 30, 2018, the return on average assets was 0.80%, the return on average stockholders' equity was 12.64%, and the efficiency ratio was 73.49%.

Consolidated net income of $5.0 million, or $0.83 per diluted share, for the six months ended June 30, 2018 increased $977,000 compared to $4.0 million, or $0.66 per diluted share, for the six months ended June 30, 2017. For the six months ended June 30, 2018, the return on average assets was 0.70%, the return on average stockholders' equity was 11.00%, and the efficiency ratio was 75.98%.

***Net interest income*** was $11.0 million and $21.8 million for the three and six months ended June 30, 2018, respectively, compared to $10.8 million and $21.3 million for the three and six months ended June 30, 2017, respectively. The net interest margin (expressed on a fully taxable equivalent basis) decreased to 3.25% for the three months ended June 30, 2018, compared to 3.50% for the three months ended June 30, 2017, and decreased to 3.27% for the six months ended June 30, 2018 compared to 3.49% for the six months ended June 30, 2017. These changes are discussed in greater detail under the *Average Balance Sheets and Rate and Volume Analysis* section below.

A $450,000 and $750,000 ***provision for loan losses*** was recorded for the three and six months ended June 30, 2018, respectively, compared to a $330,000 and $680,000 provision for the three and six months ended June 30, 2017, respectively.

The Company’s net loan charge-offs were $185,000, or 0.02%, of average loans, and $390,000, or 0.04%, of average loans for the three and six months ended June 30, 2018, respectively, compared to $47,000, or 0.00%, of average loans, and $21,000, or 0.00%, of average loans for the three and six months ended June 30, 2017, respectively.

Non-performing loans totaled $10.3 million, or 0.94% of total loans, at June 30, 2018 compared to $10.7 million, or 1.00% of total loans, at December 31, 2017, and $10.0 million, or 0.97% of total loans, at June 30, 2017. These changes are discussed in greater detail under the *Lending and Credit Management* section below.

***Non-interest income*** increased $387,000, or 18.4%, for the three months ended June 30, 2018 compared to the three months ended June 30, 2017, and increased $281,000, or 6.2%, for the six months ended June 30, 2018 compared to the six months ended June 30, 2017. These changes are discussed in greater detail below under Non-interest Income.

***Non-interest expense*** increased $244,000, or 2.5%, for the three months ended June 30, 2018 compared to the three months ended June 30, 2017 and increased $1.1 million, or 6.0%, for the six months ended June 30, 2018 compared to the six months ended June 30, 2017. These changes are discussed in greater detail below under Non-interest Expense.

***Average Balance Sheets***

*Net interest income* is the largest source of revenue resulting from the 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. 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 periods ended June 30, 2018 and 2017, respectively.

| (In thousands) | Three Months Ended June 30, 2018 | | | 2017 | | |
|---|---|---|---|---|---|---|
| | 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 | $203,512 | $ 2,549 | 5.02 % | $190,888 | $ 2,229 | 4.68 % |
| Real estate construction - residential | 29,699 | 390 | 5.27 | 20,559 | 236 | 4.60 |
| Real estate construction - commercial | 102,155 | 1,233 | 4.84 | 71,661 | 798 | 4.47 |
| Real estate mortgage - residential | 247,360 | 2,967 | 4.81 | 258,958 | 2,959 | 4.58 |
| Real estate mortgage - commercial | 475,326 | 5,524 | 4.66 | 451,185 | 5,204 | 4.63 |
| Consumer | 32,664 | 313 | 3.84 | 31,801 | 309 | 3.90 |
| Total loans | $1,090,716 | $ 12,976 | 4.77 % | $1,025,052 | $ 11,735 | 4.59 % |
| Investment securities: (3) | | | | | | |
| U.S. Treasury | $22,020 | $ 79 | 1.44 % | $0 | $ 0 | 0.00 % |
| U.S. government and federal agency obligations | 54,236 | 241 | 1.78 | 48,888 | 176 | 1.44 |
| Obligations of states and political subdivisions | 41,319 | 234 | 2.27 | 47,721 | 266 | 2.24 |
| Mortgage-backed securities | 126,842 | 646 | 2.04 | 120,012 | 544 | 1.82 |
| Total investment securities | $244,417 | $ 1,200 | 1.97 % | $216,621 | $ 986 | 1.83 % |
| Other investments and securities, at cost | 9,458 | 115 | 4.88 | 10,588 | 94 | 3.56 |
| Federal funds sold and interest bearing deposits in other financial institutions | 39,752 | 189 | 1.91 | 4,795 | 11 | 0.92 |
| Total interest earning assets | $1,384,343 | $ 14,480 | 4.20 % | $1,257,056 | $ 12,826 | 4.09 % |
| All other assets | 83,987 | | | 88,361 | | |
| Allowance for loan losses | (11,100 ) | | | (10,385 ) | | |
| Total assets | $1,457,230 | | | $1,335,032 | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | | | |
| NOW accounts | $229,171 | $ 559 | 0.98 % | $212,226 | $ 272 | 0.51 % |
| Savings | 97,144 | 12 | 0.05 | 100,985 | 13 | 0.05 |
| Interest checking | 3,894 | 6 | 0.62 | 1,523 | 2 | 0.53 |
| Money market | 291,789 | 770 | 1.06 | 203,697 | 188 | 0.37 |
| Time deposits | 314,620 | 832 | 1.06 | 286,461 | 509 | 0.71 |
| Total interest bearing deposits | $936,618 | $ 2,179 | 0.93 % | $804,892 | $ 984 | 0.49 % |
| Federal funds purchased and securities sold under agreements to repurchase | 49,571 | 189 | 1.53 | 29,237 | 27 | 0.37 |
| Federal Home Loan advances and other | 77,648 | 332 | 1.72 | 110,124 | 419 | 1.53 |
| Subordinated notes | 49,486 | 561 | 4.55 | 49,486 | 431 | 3.49 |
| Total borrowings | $176,705 | $ 1,082 | 2.46 % | $188,847 | $ 877 | 1.86 % |
| Total interest bearing liabilities | $1,113,323 | $ 3,261 | 1.17 % | $993,739 | $ 1,861 | 0.75 % |
| Demand deposits | 239,921 | | | 235,232 | | |
| Other liabilities | 11,708 | | | 11,075 | | |
| Total liabilities | 1,364,952 | | | 1,240,046 | | |
| Stockholders' equity | 92,278 | | | 94,986 | | |

| | | | | |
|---|---|---|---|---|
| Total liabilities and stockholders' equity | $1,457,230 | | $1,335,032 | |
| Net interest income (FTE) | 11,219 | | 10,965 | |
| Net interest spread | | 3.03 % | | 3.34 % |
| Net interest margin | | 3.25 % | | 3.50 % |

(1) Interest income and yields are presented on a fully taxable equivalent basis using the federal statutory income tax rate of 21% and 34%, net of nondeductible interest expense for the three months ended June 30, 2018 and 2017 respectively. Such adjustments totaled $192,000 and $145,000 for the three months ended June 30, 2018 and 2017, 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.

37

| **(In thousands)** | Six Months Ended June 30, **2018** | | | **2017** | | |
|---|---|---|---|---|---|---|
| | 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 | $197,141 | $ 4,807 | 4.92 % | $186,741 | $ 4,290 | 4.63 % |
| Real estate construction - residential | 29,088 | 731 | 5.07 | 19,936 | 451 | 4.56 |
| Real estate construction - commercial | 102,006 | 2,406 | 4.76 | 68,952 | 1,518 | 4.44 |
| Real estate mortgage - residential | 247,469 | 5,826 | 4.75 | 259,750 | 5,882 | 4.57 |
| Real estate mortgage - commercial | 473,635 | 10,884 | 4.63 | 442,219 | 10,097 | 4.60 |
| Consumer | 32,504 | 607 | 3.77 | 31,022 | 609 | 3.96 |
| Total loans | $1,081,843 | $ 25,261 | 4.71 % | $1,008,620 | $ 22,847 | 4.57 % |
| Investment securities: (3) | | | | | | |
| U.S. Treasury | $19,773 | $ 139 | 1.42 % | $0 | $ 0 | 0.00 % |
| U.S. government and federal agency obligations | 51,830 | 431 | 1.68 | 47,159 | 332 | 1.42 |
| Obligations of states and political subdivisions | 43,054 | 503 | 2.36 | 45,738 | 516 | 2.28 |
| Mortgage-backed securities | 126,152 | 1,325 | 2.12 | 122,154 | 1,126 | 1.86 |
| Total investment securities | $240,809 | $ 2,398 | 2.01 % | $215,051 | $ 1,974 | 1.85 % |
| Other investments and securities, at cost | 9,683 | 225 | 4.69 | 10,189 | 184 | 3.64 |
| Federal funds sold and interest bearing deposits in other financial institutions | 32,204 | 295 | 1.85 | 13,179 | 60 | 0.92 |
| Total interest earning assets | $1,364,539 | $ 28,179 | 4.16 % | $1,247,039 | $ 25,065 | 4.05 % |
| All other assets | 84,549 | | | 89,308 | | |
| Allowance for loan losses | (11,009 ) | | | (10,195 ) | | |
| Total assets | $1,438,079 | | | $1,326,152 | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | | | |
| NOW accounts | $236,053 | $ 1,092 | 0.93 % | $214,140 | $ 504 | 0.47 % |
| Savings | 95,758 | 24 | 0.05 | 100,409 | 25 | 0.05 |
| Interest checking | 2,755 | 10 | 0.73 | 1,589 | 4 | 0.51 |
| Money market | 279,079 | 1,305 | 0.94 | 201,709 | 331 | 0.33 |
| Time deposits | 302,363 | 1,480 | 0.99 | 291,382 | 980 | 0.86 |
| Total interest bearing deposits | $916,008 | $ 3,911 | 0.86 % | $809,229 | $ 1,844 | 0.46 % |
| Federal funds purchased and securities sold under agreements to repurchase | 46,333 | 360 | 1.57 | 29,158 | 49 | 0.34 |
| Federal Home Loan advances and other | 85,302 | 728 | 1.72 | 101,399 | 741 | 1.47 |
| Subordinated notes | 49,486 | 1,051 | 4.28 | 49,486 | 840 | 3.42 |
| Total borrowings | $181,121 | $ 2,139 | 2.38 % | $180,043 | $ 1,630 | 1.83 % |
| Total interest bearing liabilities | $1,097,129 | $ 6,050 | 1.11 % | $989,272 | $ 3,474 | 0.71 % |
| Demand deposits | 237,041 | | | 232,016 | | |
| Other liabilities | 12,297 | | | 11,198 | | |
| Total liabilities | 1,346,467 | | | 1,232,486 | | |
| Stockholders' equity | 91,612 | | | 93,666 | | |

| | | | | |
|---|---|---|---|---|
| Total liabilities and stockholders' equity | $1,438,079 | | $1,326,152 | |
| Net interest income (FTE) | 22,129 | | 21,591 | |
| Net interest spread | | 3.05 % | | 3.34 % |
| Net interest margin | | 3.27 % | | 3.49 % |

(1) Interest income and yields are presented on a fully taxable equivalent basis using the federal statutory income tax rate of 21% and 34%, net of nondeductible interest expense for the six months ended June 30, 2018 and 2017 respectively. Such adjustments totaled $347,000 and $284,000 for the six months ended June 30, 2018 and 2017, 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.

***Rate and Volume Analysis***

The following table summarizes the changes in net interest income on a fully taxable equivalent basis, by major category of interest earning assets and interest bearing liabilities, identifying changes related to volumes and rates for the three and six months ended June 30, 2018 compared to the three and six months ended June 30, 2017. 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, 2018 vs. 2017 | | | Six Months Ended June 30, 2018 vs. 2017 | | |
|---|---|---|---|---|---|---|
| | | Change due to | | | Change due to | |
| **(In thousands)** | Total **Change** | Average **Volume** | Average **Rate** | Total **Change** | Average **Volume** | Average **Rate** |
| Interest income on a fully taxable equivalent basis: (1) | | | | | | |
| Loans: (2) (4) | | | | | | |
| Commercial | $320 | $152 | $168 | $517 | $246 | $271 |
| Real estate construction - residential | 154 | 116 | 38 | 280 | 225 | 55 |
| Real estate construction - commercial | 435 | 364 | 71 | 888 | 773 | 115 |
| Real estate mortgage - residential | 8 | (136) | 144 | (56) | (284) | 228 |
| Real estate mortgage - commercial | 320 | 280 | 40 | 787 | 721 | 66 |
| Consumer | 4 | 8 | (4) | (2) | 28 | (30) |
| Investment securities: (3) | | | | | | |
| U.S. Treasury | 79 | 75 | 4 | 139 | 134 | 5 |
| U.S. government and federal agency obligations | 65 | 20 | 45 | 99 | 35 | 64 |
| Obligations of states and political subdivisions | (32) | (37) | 5 | (13) | (31) | 18 |
| Mortgage-backed securities | 102 | 32 | 70 | 199 | 38 | 161 |
| Other investments and securities, at cost | 21 | (11) | 32 | 41 | (9) | 50 |
| Federal funds sold and interest bearing deposits in other financial institutions | 178 | 155 | 23 | 235 | 139 | 96 |
| Total interest income | 1,654 | 1,018 | 636 | 3,114 | 2,015 | 1,099 |
| Interest expense: | | | | | | |
| NOW accounts | 287 | 24 | 263 | 588 | 57 | 531 |
| Savings | (1) | 0 | (1) | (1) | (1) | 0 |
| Interest checking | 4 | 0 | 4 | 6 | 4 | 2 |
| Money market | 582 | 110 | 472 | 974 | 167 | 807 |
| Time deposits | 323 | 54 | 269 | 500 | 38 | 462 |
| Federal funds purchased and securities sold under agreements to repurchase | 162 | 30 | 132 | 311 | 44 | 267 |
| Federal Home Loan Bank advances and other | (87) | (135) | 48 | (13) | (128) | 115 |
| Subordinated notes | 130 | 0 | 130 | 211 | 0 | 211 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total interest expense | 1,400 | 83 | 1,317 | 2,576 | 181 | 2,395 |
| Net interest income on a fully taxable equivalent basis | $254 | $935 | $(681) | $538 | $1,834 | $(1,296) |

(1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 21%, net of nondeductible interest expense for the three and six months ended June 30, 2018, respectively, compared to 34% for the three and six months ended June 30, 2017, respectively. Such adjustments totaled $192,000 and $347,000 for the three months and six months ended June 30, 2018, respectively, compared to $145,000 and $284,000 for the three and six months ended June 30, 2017, 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.

Financial results for the quarter ended June 30, 2018 compared to the quarter ended June 30, 2017, reflected an increase in net interest income, on a tax equivalent basis, of $254,000, or 2.32%, and financial results for the six months ended June 30, 2018 compared to the six months ended June 30, 2017 reflected an increase of $538,000, or 2.49%. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) decreased to 3.25% for the quarter ended June 30, 2018, compared to 3.50% for the quarter ended June 30, 2017, and decreased to 3.27% for the six months ended June 30, 2018 compared to 3.49% for the six months ended June 30, 2017. Although net interest income increased primarily due to an increase in average earning assets, net interest margin decreased due to the cost of interest bearing liabilities repriced faster than the rate earned on interest bearing assets in the comparative periods presented.

Average interest-earning assets increased $127.3 million, or 10.13%, to $1.38 billion for the three months ended June 30, 2018 compared to $1.26 billion for the three months ended June 30, 2017, and average interest bearing liabilities increased $119.6 million, or 12.03%, to $1.11 billion for the three months ended June 30, 2018 compared to $993.7 million for the three months ended June 30, 2017.

Average interest-earning assets increased $117.5 million, or 9.42%, to $1.36 billion for the six months ended June 30, 2018 compared to $1.25 billion for the six months ended June 30, 2017, and average interest bearing liabilities increased $107.9 million, or 10.90%, to $1.09 billion for the six months ended June 30, 2018 compared to $989.3 million for the six months ended June 30, 2017.

***Total interest income*** (expressed on a fully taxable equivalent basis) was $14.5 million and $28.2 million for the three and six months ended June 30, 2018, respectively, compared to $12.8 million and $25.1 million for the three and six months ended June 30, 2017, respectively. The Company's rates earned on interest earning assets were 4.20% and 4.16% for the three and six months ended June 30, 2018, respectively, compared to 4.09% and 4.05% for the three and six months ended June 30, 2017, respectively.

***Interest income on loans*** increased to $13.0 million and $25.3 million for the three and six months ended June 30, 2018, respectively, compared to $11.7 million and $22.8 million for the three and six months ended June 30, 2017, respectively.

Average loans outstanding increased $65.7 million, or 6.41%, to $1.09 billion for the three months ended June 30, 2018 compared to $1.02 billion for the three months ended June 30, 2017. The average yield on loans receivable increased to 4.77% for the three months ended June 30, 2018 compared to 4.59% for the three months ended June 30, 2017.

Average loans outstanding increased $73.2 million, or 7.26%, to $1.08 billion for the six months ended June 30, 2018 compared to $1.01 billion for the six months ended June 30, 2017. The average yield on loans receivable increased to 4.71% for the six months ended June 30, 2018 compared to 4.57% for the six months ended June 30, 2017. See the *Lending and Credit Management* section for further discussion of changes in the composition of the lending portfolio.

***Total interest expense*** increased to $3.3 million and $6.1 million for the three and six months ended June 30, 2018, respectively, compared to $1.9 million and $3.5 million for the three and six months ended June 30, 2017, respectively. The Company's rates paid on interest bearing liabilities was 1.17% and 1.11% for the three and six months ended June 30, 2018, respectively, compared to 0.75% and 0.71% for the three and six months ended June 30, 2017, respectively. See the *Liquidity Management* section for further discussion.

***Interest expense on deposits*** increased to $2.2 million and $3.9 million for the three and six months ended June 30, 2018, respectively, compared to $984,000 and $1.8 million for the three and six months ended June 30, 2017, respectively.

Average interest bearing deposits increased $131.7 million, or 16.4%, to $936.6 million for the three months ended June 30, 2018 compared to $804.9 million for the three months ended June 30, 2017. The increase was primarily due to a new money market product that brought in new deposits in addition to new public funds. The average cost of deposits increased to 0.93% for the three months ended June 30, 2018 compared to 0.49% for the three months ended June 30, 2017. The increase was primarily due to the rate paid on the new money market product and generally higher market interest rates during the first quarter of 2018.

Average interest bearing deposits increased $106.8 million, or 13.2%, to $916.0 million for the six months ended June 30, 2018 compared to $809.2 million for the six months ended June 30, 2017. The increase was primarily due to a new money market product that brought in new deposits in addition to new public funds. The average cost of deposits increased to 0.86% for the six months ended June 30, 2018 compared to 0.46% for the six months ended June 30, 2017. The increase was primarily due to the rate paid on the new money market product and generally higher market interest rates during the current year versus the prior year.

***Interest expense on borrowings*** increased to $1.1 million and $2.1 million for the three and six months ended June 30, 2018, respectively, compared to $877,000 and $1.6 million for the three and six months ended June 30, 2017, respectively.

Average borrowings decreased to $176.7 million for the three months ended June 30, 2018 compared to $188.8 million for the three months ended June 30, 2017. The primary decrease in average borrowings resulted from the repayment of FHLB advances partially offset by an increase in average repurchase agreements due to a tax initiative involving a short sale of a U.S. Treasury security funded by a repurchase agreement. The average cost of borrowings increased to 2.46% for the three months ended June 30, 2018 compared to 1.86% for the three months ended June 30, 2017. The increase in cost of funds, primarily resulted from higher interest rates and the additional interest cost of the repurchase agreement related to the short sale.

Average borrowings increased to $181.1 million for the six months ended June 30, 2018 compared to $180.0 million for the six months ended June 30, 2017. The primary increase in average borrowings resulted from FHLB advances to fund loan growth and a tax initiative involving short sales of U.S. Treasury securities funded by repurchase agreements. The average cost of borrowings increased to 2.38% for the six months ended June 30, 2018 compared to 1.83% for the six months ended June 30, 2017. The increase in cost of funds primarily resulted from higher interest rates and the additional interest cost of the repurchase agreements related to the short sales. See the *Liquidity Management* section for further discussion.

40

*Non-interest Income and Expense*

**Non-interest income for the periods indicated was as follows:**

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| **(In thousands)** | **2018** | **2017** | **$ Change** | **% Change** | **2018** | **2017** | **$ Change** | **% Change** |
| Non-interest Income | | | | | | | | |
| Service charges and other fees | $941 | $851 | $ 90 | 10.6 % | $1,817 | $1,687 | $ 130 | 7.7 % |
| Bank card income and fees | 709 | 663 | 46 | 6.9 | 1,365 | 1,277 | 88 | 6.9 |
| Trust department income | 311 | 266 | 45 | 16.9 | 592 | 540 | 52 | 9.6 |
| Real estate servicing fees, net | 161 | 34 | 127 | 373.5 | 381 | 487 | (106 ) | (21.8 ) |
| Gain on sales of mortgage loans, net | 242 | 218 | 24 | 11.0 | 387 | 374 | 13 | 3.5 |
| Other | 122 | 67 | 55 | 82.1 | 245 | 141 | 104 | 73.8 |
| Total non-interest income | $2,486 | $2,099 | $ 387 | 18.4 % | $4,787 | $4,506 | $ 281 | 6.2 % |
| | | | | | | | | |
| Non-interest income as a % of total revenue * | 18.4 % | 16.2 % | | | 18.0 % | 17.5 % | | |

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

***Total non-interest income*** increased $387,000, or 18.4%, to $2.5 million for the quarter ended June 30, 2018 compared to $2.1 million for the quarter ended June 30, 2017, and increased $281,000, or 6.2%, to $4.8 million for the six months ended June 30, 2018 compared to $4.5 million for the six months ended June 30, 2017.

***Service charges and other fees*** increased $90,000, or 10.6%, to $941,000 for the quarter ended June 30, 2018 compared to $851,000 for the quarter ended June 30, 2017, and increased $130,000, or 7.7%, to $1.8 million for the six months ended June 30, 2018 compared to $1.7 million for the six months ended June 30, 2017. The increases period over period primarily were a result of stronger Company policies in regards to waiving service charges and increases in fees and ATM income resulting from deposit growth.

***Real estate servicing fees, net*** of the change in valuation of mortgage serving rights (MSRs) increased $127,000 to $161,000 for the quarter ended June 30, 2018 compared to $34,000 for the quarter ended June 30, 2017 primarily due to an increase in the change in fair value quarter over quarter. Real estate servicing fees, net of the change in valuation of mortgage serving rights decreased $106,000 to $381,000 for the six months ended June 30, 2018 compared to $487,000 for the six months ended June 30, 2017 primarily due to a decrease in the change in fair value year over year. The change in the value of MSRs in both periods presented is primarily the result of market-driven changes in

interest rates and prepayment speeds.

Mortgage loan servicing fees earned on loans sold were $210,000 and $413,000 for the three and six months ended June 30, 2018, respectively, compared to $211,000 and $420,000 for the three and six months ended June 30, 2017, respectively. The Company was servicing $284.9 million of mortgage loans at June 30, 2018 compared to $285.8 million and $289.8 million at December 31, 2017 and June 30, 2017, respectively.

***Gain on sales of mortgage loans*** increased $24,000, or 11.0%, to $242,000 for the quarter ended June 30, 2018 compared to $218,000 for the quarter ended June 30, 2017, and increased $13,000, or 3.5%, to $387,000 for the six months ended June 30, 2018 compared to $374,000 for the six months ended June 30, 2017. The increase period over period was primarily due to an increase in loans sold partially offset by an increase in loan origination costs. The Company sold loans of $12.1 million and $19.7 million for the three and six months ended June 30, 2018, respectively, compared to $9.4 and $16.2 million for the three and six months ended June 30, 2017, respectively.

***Other Income*** increased $55,000, or 82.1%, to $122,000 for the quarter ended June 30, 2018 compared to $67,000 for the quarter ended June 30, 2017, and increased $104,000, or 73.8%, to $245,000 for the six months ended June 30, 2018 compared to $141,000 for the six months ended June 30, 2017. The increase period over period was primarily due to gain on the sale of investment securities partially offset by a decrease in brokerage income.

**Non-interest expense for the periods indicated was as follows:**

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| **(In thousands)** | **2018** | **2017** | **$ Change** | **% Change** | **2018** | **2017** | **$ Change** | **% Change** |
| Non-interest Expense | | | | | | | | |
| Salaries | $4,248 | $4,010 | $ 238 | 5.9 % | $8,800 | $8,064 | $ 736 | 9.1 % |
| Employee benefits | 1,565 | 1,326 | 239 | 18.0 | 3,070 | 2,710 | 360 | 13.3 |
| Occupancy expense, net | 725 | 689 | 36 | 5.2 | 1,413 | 1,307 | 106 | 8.1 |
| Furniture and equipment expense | 685 | 634 | 51 | 8.0 | 1,320 | 1,232 | 88 | 7.1 |
| Processing expense, network and bank card expense | 889 | 927 | (38 ) | (4.1 ) | 1,747 | 1,972 | (225 ) | (11.4 ) |
| Legal, examination, and professional fees | 201 | 317 | (116 ) | (36.6 ) | 624 | 597 | 27 | 4.5 |
| FDIC insurance assessment | 146 | 115 | 31 | 27.0 | 301 | 216 | 85 | 39.4 |
| Advertising and promotion | 291 | 265 | 26 | 9.8 | 544 | 503 | 41 | 8.2 |
| Postage, printing, and supplies | 224 | 252 | (28 ) | (11.1 ) | 492 | 475 | 17 | 3.6 |
| Other | 957 | 1,152 | (195 ) | (16.9 ) | 1,875 | 1,961 | (86 ) | (4.4 ) |
| Total non-interest expense | $9,931 | $9,687 | $ 244 | 2.5 % | $20,186 | $19,037 | $ 1,149 | 6.0 % |
| Efficiency ratio * | 73.5 % | 75.0 % | | | 76.0 % | 73.8 % | | |
| Number of full-time equivalent employees | 323 | 336 | | | | | | |

* Efficiency ratio is calculated as non-interest expense as a percent of revenue.

Total revenue includes net interest income and non-interest income.

***Total non-interest expense*** increased $244,000, or 2.5%, to $9.9 million for the quarter ended June 30, 2018 compared to $9.7 million for the quarter ended June 30, 2017, and increased $1.1 million, or 6.0%, to $20.2 million for the six months ended June 30, 2018 compared to $19.0 million for the six months ended June 30, 2017.

***Salaries*** increased $238,000, or 5.9%, to $4.2 million for the quarter ended June 30, 2018 compared to $4.0 million for the quarter ended June 30, 2017, and increased $736,000, or 9.1%, to $8.8 million for the six months ended June 30, 2018 compared to $8.1 million for the six months ended June 30, 2017. The increase quarter over quarter was primarily due to merit increases, and the increase for the six month period year over year was primarily due to a bonus that was paid in February 2018 to all eligible full-time and part-time employees as a result of the expected tax savings from the new tax reform.

***Employee benefits*** increased $239,000, or 18.0%, to $1.6 million for the quarter ended June 30, 2018 compared to $1.3 million for the quarter ended June 30, 2017, and increased $360,000, or 13.3%, to $3.1 million for the six months ended June 30, 2018 compared to $2.7 million for the six months ended June 30, 2017. The increase in both periods presented was primarily due to an increase in medical plan premiums effective July 1, 2018 and an increase in pension expense due to a decrease in discount rates.

***Processing, network, and bank card expense*** decreased $38,000, or 4.1%, to $889,000 for the quarter ended June 30, 2018 compared to $927,000 for the quarter ended June 30, 2017, and decreased $225,000, or 11.4%, to $1.7 million for the six months ended June 30, 2018 compared to $2.0 million for the six months ended June 30, 2017. The decrease in both periods presented was primarily due to additional one-time costs associated with a corporate wide network upgrade and changes in processing service providers during 2017.

***Legal, examination, and professional fees*** decreased $116,000, or 36.6%, to $201,000 for the quarter ended June 30, 2018 compared to $317,000 for the quarter ended June 30, 2017, and increased $27,000, or 4.5%, to $624,000 for the six months ended June 30, 2018 compared to $597,000 for the six months ended June 30, 2017. The decrease quarter over quarter was primarily due to reimbursement of attorney fees related to settlements on two loan relationships. The increase for the six month period year over year was primarily related to an increase in consulting fees related to tax planning initiatives and audit fees partially offset by a decrease in legal fees.

***FDIC insurance assessment*** increased $31,000, or 27.0%, to $146,000 for the quarter ended June 30, 2018 compared to $115,000 for the quarter ended June 30, 2017, and increased $85,000, or 39.4%, to $301,000 for the six months ended June 30, 2018 compared to $216,000 for the six months ended June 30, 2017. The increase in both periods presented was primarily due to an increase in the Company’s total assessment base.

***Other expense*** decreased $195,000, or 16.9%, to $957,000 for the quarter ended June 30, 2018 compared to $1.2 million for the quarter ended June 30, 2017, and decreased $86,000, or 4.4%, to $1.9 million for the six months ended June 30, 2018 compared to $2.0 million for the six months ended June 30, 2017. The decrease in both periods presented was primarily due to a decrease in real estate foreclosure expense, partially offset by increases in other loan expense, correspondent bank and deposit fees, and miscellaneous charged off items.

***Income taxes***

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 7.2% and 11.3% for the three and six months ended June 30, 2018, respectively, compared to 33.9% and 34.1% for the three and six months ended June 30, 2017, respectively. As further described below, the decrease in tax rate for the comparative periods is primarily due to a decrease in the federal corporate tax rate, the release of the valuation allowance related to capital losses as a result of the Company’s tax planning initiatives, a pension contribution made

during the second quarter of 2018 that was attributable to the 2017 plan year, and the Company’s additional tax planning initiatives.

The federal corporate income tax rate declined from 34% to 21% effective January 1, 2018 as a result of the Tax Cuts and Jobs Act. The Company's tax rate is lower than the federal statutory rate primarily as a result of tax-exempt income, the release of the valuation allowance related to capital loss carryforwards, and a pension contribution made during the second quarter of 2018 that was attributable to the 2017 plan year. The provisional adjustments recorded in the fourth quarter of 2017 related to the enactment of the Tax Cuts and Jobs Act have not been finalized as of June 30, 2018. The Company expects to finalize those adjustments within the one-year measurement period provided under Staff Accounting Bulletin No. 118 in regards to the application of FASB's ASC Topic 740, *Income Taxes*. The impact of the Tax Cuts and Jobs Act is expected to require further adjustments in 2018 due to anticipated additional guidance from the U.S. Department of the Treasury, changes in our assumptions, completion of 2017 U.S. tax returns and further information and interpretations that become available.

Lending and Credit Management

Interest earned on the loan portfolio is a primary source of interest income for the Company. Net loans represented 74.8% of total assets as of June 30, 2018 compared to 74.0% as of December 31, 2017.

Lending activities are conducted pursuant to an established loan policy approved by the Bank's Board of Directors. The Bank's credit review process is overseen by regional loan committees with established loan approval limits. 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 the Company's loan portfolio as of the dates indicated is as follows:

| **(In thousands)** | June 30, **2018** | December 31, **2017** |
|---|---|---|
| Commercial, financial, and agricultural | $200,628 | $ 192,238 |
| Real estate construction - residential | 28,285 | 26,492 |
| Real estate construction - commercial | 106,406 | 98,340 |
| Real estate mortgage - residential | 246,415 | 246,754 |
| Real estate mortgage - commercial | 479,571 | 472,455 |
| Installment loans to individuals | 32,890 | 32,153 |
| Total loans | $1,094,195 | $ 1,068,432 |
| Percent of categories to total loans: | | |
| Commercial, financial, and agricultural | 18.4 % | 18.0 % |
| Real estate construction - residential | 2.6 | 2.5 |
| Real estate construction - commercial | 9.7 | 9.2 |
| Real estate mortgage - residential | 22.5 | 23.1 |

| | | | | |
|---|---|---|---|---|
| Real estate mortgage - commercial | 43.8 | | 44.2 | |
| Installment loans to individuals | 3.0 | | 3.0 | |
| Total | 100.0 | % | 100.0 | % |

The Company extends credit to its local community market through traditional real estate mortgage products. The Company does not participate in extending credit to sub-prime residential real estate markets. The Company does not lend funds for transactions defined as “highly leveraged” by bank regulatory authorities or for foreign loans. Additionally, the Company does not have any concentrations of loans exceeding 10% of total loans that are not otherwise disclosed in the loan portfolio composition table. The Company does not have any interest-earning assets that would have been included in nonaccrual, past due, or restructured loans if such assets were loans.

The 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 the Company has a non-recourse purchase commitment from the secondary market at a predetermined price. During the three and six months ended June 30, 2018, the Company sold approximately $12.1 million and $19.7 million of loans to investors, respectively, compared to $9.4 million and $16.2 million for the three and six months ended June 30, 2017, respectively. At June 30, 2018, the Company was servicing approximately $284.9 million of loans sold to the secondary market compared to $285.8 million at December 31, 2017, and $289.8 million at June 30, 2017.

*Risk Elements of the Loan Portfolio*

Management, 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 $2.0 million in aggregate and all adversely classified credits identified by management are reviewed. In addition, all other loans are reviewed on a sample basis. The senior loan committee reviews and reports to the board of directors, on a monthly basis, 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 310-10-35 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 nonperforming assets at the dates indicated:

| (In thousands) | June 30, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| Nonaccrual loans: | | | | |
| Commercial, financial, and agricultural | $ | 2,429 | $ | 2,507 |
| Real estate construction - residential | | 0 | | 0 |
| Real estate construction - commercial | | 169 | | 97 |
| Real estate mortgage - residential | | 2,775 | | 1,956 |
| Real estate mortgage - commercial | | 653 | | 936 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Installment and other consumer | | 285 | | | 176 | |
| Total | $ | 6,311 | | $ | 5,672 | |
| Loans contractually past - due 90 days or more and still accruing: | | | | | | |
| Commercial, financial, and agricultural | $ | 0 | | $ | 2 | |
| Real estate construction - residential | | 0 | | | 275 | |
| Real estate mortgage - residential | | 8 | | | 28 | |
| Installment and other consumer | | 34 | | | 23 | |
| Total | $ | 42 | | $ | 328 | |
| Performing troubled debt restructurings | | 3,940 | | | 4,684 | |
| Total nonperforming loans | | 10,293 | | | 10,684 | |
| Other real estate owned and repossessed assets | | 13,236 | | | 13,182 | |
| Total nonperforming assets | $ | 23,529 | | $ | 23,866 | |
| | | | | | | |
| Loans | $ | 1,094,195 | | $ | 1,068,432 | |
| Allowance for loan losses to loans | | 1.02 | % | | 1.02 | % |
| Nonperforming loans to loans | | 0.94 | % | | 1.00 | % |
| Allowance for loan losses to nonperforming loans | | 108.93 | % | | 101.57 | % |
| Allowance for loan losses to nonperforming loans, excluding performing TDR's | | 176.48 | % | | 180.87 | % |
| Nonperforming assets to loans, other real estate owned and repossessed assets | | 2.12 | % | | 2.21 | % |

Total nonperforming assets totaled $23.5 million at June 30, 2018 compared to $23.9 million at December 31, 2017. Nonperforming loans, defined as loans on nonaccrual status, loans 90 days or more past due and still accruing, and TDRs totaled $10.3 million, or 0.94%, of total loans at June 30, 2018 compared to $10.7 million, or 1.00%, of total loans at December 31, 2017. Non-accrual loans included $2.0 million and $1.7 million of loans classified as TDRs at

June 30, 2018 and December 31, 2017, respectively.

As of June 30, 2018 and December 31, 2017, approximately $2.2 million and $4.1 million, respectively, of loans classified as substandard, not included in the nonperforming asset table, were identified as potential problem loans having more than normal risk which raised doubts as to the ability of the borrower to comply with present loan repayment terms. Management believes the general allowance was sufficient to cover the risks and probable losses related to such loans at June 30, 2018 and December 31, 2017, respectively.

Total non-accrual loans at June 30, 2018 increased $639,000, or 11.0%, to $6.3 million compared to $5.7 million at December 31, 2017. This increase primarily consisted of an increase in real estate mortgage - residential loans and installment loans, partially offset by a decrease in real estate mortgage – commercial loans and commercial financial, and agricultural loans.

Loans past due 90 days and still accruing interest at June 30, 2018, were $42,000 compared to $328,000 at December 31, 2017. Other real estate and repossessed assets were $13.2 million at both June 30, 2018 and December 31, 2017. During the six months ended June 30, 2018, $382,000 of nonaccrual loans, net of charge-offs taken, moved to other real estate owned and repossessed assets compared to $103,000 during the six months ended June 30, 2017.

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

| | June 30, 2018 | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| **(In thousands)** | **Number of Contracts** | **Recorded Investment** | **Specific Reserves** | **Number of Contracts** | **Recorded Investment** | **Specific Reserves** |
| Performing TDRs | | | | | | |
| Commercial, financial and agricultural | 5 | $ 458 | $ 19 | 6 | $ 500 | $ 20 |
| Real estate mortgage - residential | 10 | 2,410 | 80 | 11 | 3,116 | 236 |
| Real estate mortgage - commercial | 2 | 1,053 | 63 | 2 | 1,068 | 109 |
| Intallment - Consumer | 2 | 19 | 1 | - | - | - |
| Total performing TDRs | 19 | $ 3,940 | $ 163 | 19 | $ 4,684 | $ 365 |
| Nonperforming TDRs | | | | | | |
| Commercial, financial and agricultural | 4 | $ 790 | $ 45 | 4 | $ 838 | $ 41 |
| Real estate mortgage - residential | 5 | 879 | 210 | 4 | 290 | 61 |
| Real estate mortgage - commercial | 4 | 271 | 91 | 4 | 589 | 110 |
| Intallment - Consumer | 2 | 28 | 1 | - | - | - |
| Total nonperforming TDRs | 15 | $ 1,968 | $ 347 | 12 | $ 1,717 | $ 212 |
| Total TDRs | 34 | $ 5,908 | $ 510 | 31 | $ 6,401 | $ 577 |

At June 30, 2018, loans classified as TDRs totaled $5.9 million, with $510,000 of specific reserves, of which $2.0 million were classified as nonperforming TDRs and $3.9 million were classified as performing TDRs. This compared to $6.4 million of loans classified as TDRs, with $577,000 of specific reserves, of which $1.7 million were classified as nonperforming TDRs and $4.7 million were classified as performing TDRs at December 31, 2017. 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. The net decrease in total TDRs from December 31, 2017 to June 30, 2018 was primarily due to one TDR totaling $48,000 that went to foreclosure and $639,000 of payments on TDRs received, partially offset by six new TDRs totaling $191,000.

**Allowance for Loan Losses and Provision**

*Allowance for Loan Losses*

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

| (In thousands) | June 30, 2018 | December 31, 2017 |
|---|---|---|
| Allocation of allowance for loan losses at end of period: | | |
| Commercial, financial, and agricultural | $3,943 | $ 3,325 |
| Real estate construction - residential | 201 | 170 |
| Real estate construction - commercial | 905 | 807 |
| Real estate mortgage - residential | 2,109 | 1,689 |
| Real estate mortgage - commercial | 3,630 | 4,437 |
| Installment and other consumer | 413 | 345 |
| Unallocated | 11 | 79 |
| Total | $11,212 | $ 10,852 |

The allowance for loan losses (ALL) was $11.2 million, or 1.02%, of loans outstanding at June 30, 2018 compared to $10.9 million, or 1.02%, at December 31, 2017, and $10.5 million, or 1.02%, of loans outstanding at June 30, 2017. The ratio of the allowance for loan losses to nonperforming loans, excluding performing TDRs, was 176.48% at June 30, 2018, compared to 180.87% at December 31, 2017.

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

| (In thousands) | June 30, 2018 | December 31, 2017 |
|---|---|---|
| Allocation of allowance for loan losses: | | |
| Individually evaluated for impairment - specific reserves | $1,282 | $ 1,333 |
| Collectively evaluated for impairment - general reserves | 9,930 | 9,519 |
| Total | $11,212 | $ 10,852 |

The *specific reserve component* applies to loans evaluated individually for impairment. The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals and/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, 2018, $1.3 million of the Company’s ALL was allocated to impaired loans totaling approximately $10.3 million compared to $1.3 million of the Company’s ALL allocated to impaired loans totaling approximately $10.4 million at December 31, 2017. Management determined that $3.3 million, or 33%, of total impaired loans required no reserve allocation at June 30, 2018 compared to $2.4 million, or 23%, at December 31, 2017 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

The *incurred loss component* of the general reserve, or loans collectively evaluated for impairment, is determined by applying loss rates to pools of loans by asset type. 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. 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 by December 31, 2017. 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. These historical loss rates for each risk group are used as the starting point to determine loss rates for measurement purposes. The historical loan loss rates are multiplied by loss emergence periods (LEP) which represent the estimated time period between a borrower first experiencing financial difficulty and the recognition of a loss.

The Company’s methodology includes qualitative risk factors that allow management to adjust its estimates of losses based on the most recent information available and to address other limitations in the quantitative component that is based on historical loss rates. Such risk factors are generally reviewed and updated quarterly, as appropriate, and are adjusted to reflect changes in national and local economic conditions and developments, the nature, volume and terms of loans in the portfolio, including changes in volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans, loan concentrations, assessment of trends in collateral values, assessment of changes in the quality of the Company’s internal loan review department, and changes in lending policies and procedures, including underwriting standards and collections, charge-off and recovery practices.

The specific and general reserve allocations represent management's best estimate of probable losses inherent 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.

*Provision*

A $450,000 and $750,000 provision was required for the three and six months ended June 30, 2018, respectively, compared to a $330,000 and $680,000 provision for the three and six months ended June 30, 2017. The increase in both periods reported was primarily due to loan growth and changes in current economic factors used in assessing the risk in the portfolio.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (In thousands) | 2018 | 2017 | 2018 | 2017 |
| Analysis of allowance for loan losses: | | | | |
| Balance beginning of period | $ 10,947 | $ 10,262 | $ 10,852 | $ 9,886 |
| Charge-offs: | | | | |
| Commercial, financial, and agricultural | 193 | 32 | 303 | 60 |
| Real estate construction - residential | - | - | 48 | - |
| Real estate construction - commercial | - | - | 30 | - |
| Real estate mortgage - residential | 12 | 62 | 32 | 81 |
| Real estate mortgage - commercial | 15 | 2 | 29 | 16 |
| Installment and other consumer | 49 | 60 | 106 | 111 |
| Total charge-offs | 269 | 156 | 548 | 268 |
| Recoveries: | | | | |
| Commercial, financial, and agricultural | $ 10 | $ 24 | $ 23 | $ 42 |
| Real estate construction - residential | 13 | 25 | 25 | 75 |
| Real estate mortgage - residential | 16 | 21 | 36 | 57 |
| Real estate mortgage - commercial | 25 | 14 | 31 | 21 |
| Installment and other consumer | 20 | 25 | 43 | 52 |
| Total recoveries | 84 | 109 | 158 | 247 |
| Net charge-offs | 185 | 47 | 390 | 21 |
| Provision for loan losses | 450 | 330 | 750 | 680 |
| Balance end of period | $ 11,212 | $ 10,545 | $ 11,212 | $ 10,545 |

*Net Loan Charge-offs*

The Company’s net loan charge-offs were $185,000, or 0.02%, of average loans, and $390,000, or 0.04%, of average loans for the three and six months ended June 30, 2018, respectively, compared to $47,000, or 0.00%, of average loans, and $21,000, or 0.00%, of average loans for the three and six months ended June 30, 2017, respectively. The increase in charge-offs period over period primarily related to two commercial loan relationships.

***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 the Company, management prefers to focus on transaction accounts and full service relationships with customers.

The Company's Asset/Liability Committee (ALCO), primarily made up of senior management, has direct oversight responsibility for the 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 the Company's liquidity.

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

| **(In thousands)** | June 30, 2018 | December 31, 2017 |
|---|---|---|
| Federal funds sold and other overnight interest-bearing deposits | $34,863 | $ 39,553 |
| Certificates of deposit in other banks | 10,746 | 3,460 |
| Available-for-sale investment securities | 227,601 | 226,542 |
| Total | $273,210 | $ 269,555 |

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 $227.6 million at June 30, 2018 and included an unrealized net loss of $5.9 million. The portfolio includes projected maturities and mortgage backed securities pay-downs of approximately $12.4 million over the next twelve months, which offer resources to meet either new loan demand or reductions in the Company's deposit base.

The 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, 2018 and December 31, 2017, the Company's unpledged securities in the available for sale portfolio totaled approximately $40.3 million and $44.8 million, respectively.

Total investment securities pledged for these purposes were as follows:

| (In thousands) | June 30, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| Investment securities pledged for the purpose of securing: | | | | |
| Federal Reserve Bank borrowings | $ | 9,703 | $ | 9,570 |
| Federal funds purchased and securities sold under agreements to repurchase | | 54,767 | | 40,931 |
| Other deposits | | 122,789 | | 131,197 |
| Total pledged, at fair value | $ | 187,259 | $ | 181,698 |

Liquidity is available from the Company's base of core customer deposits, defined as demand, interest checking, savings, money market deposit accounts, and time deposits less than $250,000, less all brokered deposits under $250,000. At June 30, 2018, such deposits totaled $1.1 billion and represented 90.0% of the Company's total deposits. These core deposits are normally less volatile and are often tied to other products of the Company through long lasting relationships. Time deposits and certificates of deposit of $250,000 and over totaled $98.6 million at June 30, 2018. These accounts are normally considered more volatile and higher costing representing 8.3% of total deposits at June 30, 2018.

Core deposits at June 30, 2018 and December 31, 2017 were as follows:

| (In thousands) | June 30, 2018 | December 31, 2017 |
|---|---|---|
| Core deposit base: | | |
| Non-interest bearing demand | $250,232 | $ 245,380 |
| Interest checking | 217,259 | 229,862 |

| | | |
|---|---|---|
| Savings and money market | 381,650 | 345,593 |
| Other time deposits | 216,075 | 230,309 |
| Total | $1,065,216 | $ 1,051,144 |

The total amount of certificates of deposit of $250,000 and greater at June 30, 2018 and December 31, 2017 were $98.6 million and $63.2 million, respectively. The Company had brokered deposits totaling $16.8 million and $9.8 million at June 30, 2018 and December 31, 2017, respectively. Under the Economic Growth, Regulatory Relief, and Consumer Protection Act signed into law in May 2018, certain reciprocal deposits are no longer required to be classified as brokered deposits. As such, prior periods presented have been reclassified to include these reciprocal deposits in the Company's core deposits and excluded from brokered deposit totals.

Other components of liquidity are the level of borrowings from third party sources and the availability of future credit. The Company's outside borrowings are comprised of securities sold under agreements to repurchase, Federal Home Loan Bank advances, and subordinated notes. Federal funds purchased are overnight borrowings obtained mainly from upstream correspondent banks with which the Company maintains approved credit lines. As of June 30, 2018, under agreements with these unaffiliated banks, the Bank may borrow up to $40.0 million in federal funds on an unsecured basis and $16.9 million on a secured basis. There were no federal funds purchased outstanding at June 30, 2018. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of the Company's investment portfolio. At June 30, 2018, there was $36.1 million in repurchase agreements. The 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, 2018.

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, 2018, the Bank had $74.2 million in outstanding borrowings with the FHLB. In addition, the Company has $49.5 million in outstanding subordinated notes issued to wholly-owned grantor trusts, funded by preferred securities issued by the trusts.

Borrowings outstanding at June 30, 2018 and December 31, 2017 were as follows:

| (In thousands) | June 30, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| Borrowings: | | | | |
| Federal funds purchased and securities sold under agreements to repurchase | $ | 36,103 | $ | 27,560 |
| Federal Home Loan Bank advances | | 74,240 | | 121,352 |
| Subordinated notes | | 49,486 | | 49,486 |
| Other borrowings | | 30 | | 30 |
| Total | $ | 159,859 | $ | 198,428 |

The 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, the FHLB establishes a collateral value from which the Company may draw advances against this collateral. This collateral is also used to enable the FHLB to issue letters of credit in favor of public fund depositors of the Company. The Federal Reserve Bank also establishes a collateral value of assets pledged to support borrowings from the discount window. The following table reflects collateral value of assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to the Company as follows:

| | June 30, 2018 | | | | December 31, 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| (In thousands) | FHLB | **Federal Reserve Bank** | **Federal Funds Purchased Lines** | Total | FHLB | **Federal Reserve Bank** | **Federal Funds Purchased Lines** | Total |
| Advance equivalent | $283,580 | $ 9,483 | $ 47,385 | $340,448 | $294,081 | $ 9,364 | $ 47,825 | $351,270 |
| Letters of credit | (73,750 ) | 0 | 0 | (73,750 ) | (70,000 ) | 0 | 0 | (70,000 ) |
| Advances outstanding | (74,240 ) | 0 | 0 | (74,240 ) | (121,352) | 0 | 0 | (121,352) |
| Total available | $135,590 | $ 9,483 | $ 47,385 | $192,458 | $102,729 | $ 9,364 | $ 47,825 | $159,918 |

At June 30, 2018, loans of $489.6 million were pledged at the Federal Home Loan Bank as collateral for borrowings and letters of credit. At June 30, 2018, investments totaling $19.3 million 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 $50.8 million at June 30, 2018 compared to $62.9 million at December 31, 2017. The $12.1 million decrease resulted from changes in the various cash flows produced by operating, investing, and financing activities of the Company, as shown in the accompanying consolidated statement of cash flows for the six months ended June 30, 2018. Cash flow provided from operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of $6.5 million for the six months ended June 30, 2018.

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 $36.6 million. The cash outflow primarily consisted of $26.3 million increase in loans and $74.3 million purchases of investment securities, partially offset by $69.9 million from maturities, calls, and sales of investment securities.

Financing activities provided cash of $18.0 million, resulting primarily from a $30.5 million increase in interest bearing transaction accounts, a $22.2 million increase in time deposits, and an $8.5 million increase in federal funds purchased and securities sold under agreements to repurchase, partially offset by a net $47.1 million repayment of FHLB advances. Future short-term liquidity needs arising from daily operations are not expected to vary significantly during 2018.

In the normal course of business, the Company enters into certain forms of off-balance sheet transactions, including unfunded loan commitments and letters of credit. These transactions are managed through the Company's various risk management processes. Management considers both on-balance sheet and off-balance sheet transactions in its evaluation of the Company's liquidity. The Company had $315.0 million in unused loan commitments and standby letters of credit as of June 30, 2018. Although the Company's current liquidity resources are adequate to fund this commitment level the nature of these commitments is such that the likelihood of such a funding demand is very low.

The Company is a legal entity, separate and distinct from the Bank, which must provide its own liquidity to meet its operating needs. The Company’s ongoing liquidity needs primarily include funding its operating expenses and paying cash dividends to its shareholders. The Company paid cash dividends to its shareholders totaling approximately $811,000 and $674,000 for the six months ended June 30, 2018 and 2017, respectively. A large portion of the Company’s liquidity is obtained from the Bank in the form of dividends. The Bank declared and paid $4.0 million and $0 in dividends to the Company during the six months ended June 30, 2018 and 2017, respectively. At June 30, 2018 and December 31, 2017, the Company had cash and cash equivalents totaling $1.8 million and $1.4 million, respectively.

**Capital Management**

The 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 the Company's consolidated financial statements. Under capital adequacy guidelines, the 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 the Company and the Bank are subject to qualitative judgments by the regulators about components, risk-weightings, and other factors.

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for the Company began on January 1, 2015. The Federal Reserve System's (FRB) capital adequacy guidelines require that bank holding companies maintain a Common Equity Tier 1 risk-based capital ratio equal to at least 4.5% of its risk-weighted assets, a Tier 1 risk-based capital ratio equal to at least 6% of its risk-weighted assets and a total risk-based capital ratio equal to at least 8% of its risk-weighted assets. In addition, bank holding companies generally are required to maintain a Tier 1 leverage ratio of at least 4%.

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. Institutions that do not maintain the required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital conservation buffer requirement will be phased in over four years beginning in 2016. On January 1, 2016, the first phase of the requirement went into effect at 0.625% of risk-weighted assets, and the requirement will increase each subsequent year by an additional 0.625 percentage points, to reach its final level of 2.5% of risk weighted assets on January 1, 2019. Once fully phased in, the capital conservation buffer requirement effectively raises the minimum required risk-based capital ratios to 7% Common Equity Tier 1 Capital, 8.5% Tier 1 Capital and 10.5% Total Capital on a fully phased-in basis.

Under the Basel III requirements, at June 30, 2018 and December 31, 2017, the Company met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well-capitalized institutions, as shown in the following table as of periods indicated:

| (in thousands) | Actual Amount | Ratio | | Required for Capital Adequacy Purposes Amount | Ratio | | Well-Capitalized Under Prompt Corrective Action Provision Amount | Ratio | |
|---|---|---|---|---|---|---|---|---|---|
| June 30, 2018 | | | | | | | | | |
| Total Capital (to risk-weighted assets): | | | | | | | | | |
| Company | $160,239 | 13.41 | % | $ 95,573 | 8.00 | % | $ N.A. | N.A. | % |
| Bank | 156,966 | 13.18 | | 95,272 | 8.00 | | 119,090 | 10.00 | |
| Tier I Capital (to risk-weighted assets): | | | | | | | | | |
| Company | $132,937 | 11.13 | % | $ 71,680 | 6.00 | % | $ N.A. | N.A. | % |
| Bank | 145,594 | 12.23 | | 71,454 | 6.00 | | 95,272 | 8.00 | |
| Common Equity Tier I Capital (to risk-weighted assets) | | | | | | | | | |
| Company | $100,867 | 8.44 | % | $ 53,760 | 4.50 | % | $ N.A. | N.A. | % |
| Bank | 145,594 | 12.23 | | 53,590 | 4.50 | | 77,408 | 6.50 | |
| Tier I Capital (to adjusted average assets): | | | | | | | | | |
| Company | $132,937 | 9.09 | % | $ 58,492 | 4.00 | % | $ N.A. | N.A. | % |
| Bank | 145,594 | 10.14 | | 57,427 | 4.00 | | 71,783 | 5.00 | |
| **(in thousands)** | | | | | | | | | |
| December 31, 2017 | | | | | | | | | |
| Total Capital (to risk-weighted assets): | | | | | | | | | |
| Company | $156,045 | 12.93 | % | $ 96,577 | 8.00 | % | $ N.A. | N.A. | % |
| Bank | 154,495 | 12.83 | | 96,326 | 8.00 | | 120,408 | 10.00 | |
| Tier I Capital (to risk-weighted assets): | | | | | | | | | |
| Company | $129,369 | 10.72 | % | $ 72,433 | 6.00 | % | $ N.A. | N.A. | % |
| Bank | 143,483 | 11.92 | | 72,245 | 6.00 | | 96,326 | 8.00 | |
| Common Equity Tier I Capital (to risk-weighted assets) | | | | | | | | | |
| Company | $97,033 | 8.04 | % | $ 54,325 | 4.50 | % | $ N.A. | N.A. | % |
| Bank | 143,483 | 11.92 | | 54,184 | 4.50 | | 78,265 | 6.50 | |
| Tier I leverage ratio: | | | | | | | | | |
| Company | $129,369 | 9.33 | % | $ 55,488 | 4.00 | % | $ N.A. | N.A. | % |
| Bank | 143,483 | 10.38 | | 55,315 | 4.00 | | 69,144 | 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. The Company faces market risk in the form of interest rate risk through transactions other than trading activities. The

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 the 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 the Company feels it has no primary exposure to specific points on the yield curve. For the three months ended June 30, 2018, 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. However, there are no assurances that the change will not be more or less than this estimate.

The following table represents estimated interest rate sensitivity and periodic and cumulative gap positions calculated as of June 30, 2018. Significant assumptions used for this table included: loans will repay at historic repayment rates; certain interest-bearing demand accounts are interest sensitive due to immediate repricing, and fixed maturity deposits will not be withdrawn prior to maturity. A significant variance in actual results from one or more of these assumptions could materially affect the results reflected in the table.

| **(In thousands)** | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Over 5 Years or No stated Maturity | Total |
|---|---|---|---|---|---|---|---|
| ASSETS | | | | | | | |
| Investment securities | $35,669 | $46,303 | $40,062 | $35,482 | $28,853 | $41,232 | $227,601 |
| Federal funds sold and other over-night interest-bearing deposits | 34,863 | - | - | - | - | - | 34,863 |
| Certificates of deposit in other banks | - | 2,097 | 3,210 | 1,977 | 3,462 | - | 10,746 |
| Other investments and securities, at cost | 6,323 | 3,000 | - | - | - | - | 9,323 |
| Loans | 420,952 | 162,210 | 169,767 | 129,108 | 122,712 | 89,446 | 1,094,195 |
| Total | $497,807 | $213,610 | $213,039 | $166,567 | $155,027 | $130,678 | $1,376,728 |
| | | | | | | | |
| LIABILITIES | | | | | | | |
| Savings, interest checking, and money market deposits | $380,174 | $- | $234,802 | $- | $- | $- | $614,976 |
| Time deposits | 215,740 | 43,160 | 16,994 | 18,745 | 23,539 | - | 318,178 |
| Federal funds purchased and securities sold under agreements to repurchase | 36,103 | - | - | - | - | - | 36,103 |
| Federal Home Loan Bank advances | | | | | | | |
| and other borrowings | 32,228 | 30,233 | 7,238 | 4,541 | 30 | - | 74,270 |
| Subordinated notes | 49,486 | - | - | - | - | - | 49,486 |
| Total | $713,731 | $73,393 | $259,034 | $23,286 | $23,569 | $- | $1,093,013 |
| Interest-sensitivity GAP | | | | | | | |
| Periodic GAP | $(215,924) | $140,217 | $(45,995 ) | $143,281 | $131,458 | $130,678 | $283,715 |
| Cumulative GAP | $(215,924) | $(75,707 ) | $(121,702) | $21,579 | $153,037 | $283,715 | $283,715 |
| | | | | | | | |
| Ratio of interest-earning assets to interest-bearing liabilities | | | | | | | |
| Periodic GAP | 0.70 | 2.91 | 0.82 | 7.15 | 6.58 | NM | 1.26 |
| Cumulative GAP | 0.70 | 0.90 | 0.88 | 1.02 | 1.14 | 1.26 | 1.26 |

**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 the Company's operations for the six months ended June 30, 2018.

**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, 2018. 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, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Impact of New Accounting Standards**

***Financial Instruments*** In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (CECL). The revised accounting guidance will remove all recognition thresholds and will require a company to recognize an allowance for credit losses for the difference between the amortized cost basis of a financial instrument and the amount of amortized cost that the company expects to collect over the instrument's contractual life. It also amends the credit loss measurement guidance for available-for-sale debt securities and beneficial interests in securitized financial assets. This new accounting guidance will be effective for interim and annual reporting periods beginning after December 15, 2019. While the Company generally expects to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, the Company has not determined the magnitude of any such one-time adjustment or the overall impact of the new guidance on the Company’s consolidated financial statements. The Company has formed a committee and is continuing to evaluate the impact of the ASU's adoption on the Company's consolidated financial statements.

***Leases*** In February 2016, the FASB issued ASU 2016-02, *Leases*, in order to increase transparency and comparability by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The ASU primarily affects lessee accounting, which requires the lessee to recognize a right-of-use asset and a liability to make lease payments for those leases classified as operating leases under previous GAAP. For leases with a term of 12 months or less, an election by class of underlying asset not to recognize lease assets and lease liabilities is permitted. The ASU also provides additional guidance as to the definition of a lease, identification of lease components, and sale and leaseback transactions. The amendments in the ASU are effective for interim and annual periods beginning January 1, 2019. The Company expects to adopt this ASU in the first quarter of 2019 and is in the process of evaluating the impact of the ASU's adoption on the Company's consolidated financial statements.

In January 2018, the FASB issued ASU 2018-01*, Leases: Land Easement Practical Expedient for Transition to Topic 842*. This update provides an optional practical expedient that affects entities with land easements that existed or expired before an entity's adoption of Topic 842, provided that the entity does not account for those land easements as leases under Topic 840. The amendments in this ASU affect the amendments in ASU 2016-02, which are not yet effective but may be early adopted. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in ASU 2016-02. The Company will adopt this guidance as required, in conjunction with the adoption of ASU 2016-02 described above, however this update is not expected to materially alter the implementation of ASU 2016-02, or to have a material impact on the Company’s consolidated financial statements.

***Derivatives and Hedging*** The FASB issued guidance within ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities (Topic 815)* in August 2017. The amendments in ASU 2017-12 to Topic 815, Derivatives and Hedging, are intended to more closely align hedge accounting with companies' risk management strategies, simplify the application of hedge accounting, and increase transparency as to the scope and results of hedging programs. The

guidance also amends the presentation and disclosure requirements and changes how companies assess effectiveness. Under the new guidance, public companies will have until the end of the first quarter in which a hedge is designated to perform an initial assessment of a hedge's effectiveness. After initial qualification, the new guidance permits a qualitative effectiveness assessment for certain hedges instead of a quantitative test if the company can reasonably support an expectation of high effectiveness throughout the term of the hedge. Additional disclosures include cumulative basis adjustments for fair value hedges and the effect of hedging on individual income statement line items. The amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted in any interim period after issuance of the Update. The ASU is not expected to have a significant effect on the Company’s Consolidated Financial Statements.

**PART II - OTHER INFORMATION**

Item 1. Legal Proceedings

The information required by this Item is set forth in *Commitments and Contingencies, Pending Litigation,* in our Company’s Notes to Consolidated Financial Statements (*unaudited)*.

Item 1A. Risk Factors None

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table summarizes the purchases made by or on behalf of the Company or certain affiliated purchasers of shares of the Company's common stock during the three months ended June 30, 2018:

| Period | **(a) Total Number of Shares (or Units) Purchased** | **(b) Average Price Paid per Share (or Unit)** | **(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs** | **(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs *** |
|---|---|---|---|---|
| April 1-30, 2018 | 3,200 | $ 20.85 | - | $ 1,786,708 |
| May 1-31, 2018 | - | $ - | - | $ 1,786,708 |
| June 1-30, 2018 | - | $ - | - | $ 1,786,708 |
| Total | 3,200 | $ 20.85 | - | $ 1,786,708 |

* On August 6, 2015, the Company announced that its Board of Directors authorized the purchase, through open market transactions, of up to $2.0 million market value of the Company's common stock. On August 8, 2017, the Board authorized the repurchase of an additional $1.5 million market value of the Company’s common stock Management was given discretion to determine the number and pricing of the shares to be purchased, as well as, the timing of any such purchases.

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 the Company (filed as Exhibit 3.1 to the Company's current report on Form 8-K on August 9, 2007 and incorporated herein by reference). |
| 3.2 | Amended and Restated Bylaws of the Company (filed as Exhibit 3.1 to the Company's current report on Form 8-K on June 8, 2009 and incorporated herein by reference). |
| 4.1 | Specimen certificate representing shares of the Company's $1.00 par value Common Stock (filed as Exhibit 4.1 to the Company's current report on Form 8-K/A on June 23, 2017 and incorporated herein by reference). |

| | |
|---|---|
| 31.1 | Certificate of the Chief Executive Officer of the Company pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certificate of the Chief Financial Officer of the Company pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certificate of the Chief Executive Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certificate of the Chief Financial Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 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 9, 2018 | David T. Turner, Chairman of the Board and<br>Chief Executive Officer (Principal Executive Officer) |
| | /s/ W. Bruce Phelps |
| August 9, 2018 | W. Bruce Phelps, Chief Financial Officer (Principal Financial<br>Officer and Principal Accounting Officer) |

HAWTHORN BANCSHARES, INC.

INDEX TO EXHIBITS

June 30, 2018 Form 10-Q

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* 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.

57