

HAWTHORN BANCSHARES, INC.
Form 10-Q
May 08, 2009

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

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2009**

or

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

**Commission File Number: 0-23636
HAWTHORN BANCSHARES, INC.**
(Exact name of registrant as specified in its charter)

Missouri
(State or other jurisdiction
of incorporation or organization)

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

300 Southwest Longview Boulevard, Lees Summit, Missouri 64081

(Address of principal executive offices) (Zip Code)

(816) 347-8100

(Registrant's telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting
company

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

As of May 8, 2009 the registrant had 4,136,495 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

| | March 31, 2009 <i>(Unaudited)</i> | December 31, 2008 |
|--|---|------------------------------|
| ASSETS | | |
| Loans | \$1,004,530,173 | \$1,009,103,532 |
| Allowances for loan losses | (13,159,425) | (12,666,546) |
| Net loans | 991,370,748 | 996,436,986 |
| Investment in available-for-sale securities, at fair value | 146,462,294 | 149,400,929 |
| Investment in equity securities, at cost | 8,875,250 | 8,875,250 |
| Total investment securities | 155,337,544 | 158,276,179 |
| Federal funds sold and securities purchased under agreements to resell | 116,432 | 104,393 |
| Cash and due from banks | 51,442,542 | 53,723,075 |
| Premises and equipment net | 38,713,892 | 39,260,220 |
| Other real estate owned and repossessed assets | 7,473,293 | 7,828,278 |
| Accrued interest receivable | 6,995,873 | 7,476,093 |
| Mortgage servicing rights | 1,520,838 | 1,171,225 |
| Intangible assets net | 1,961,554 | 2,130,097 |
| Cash surrender value life insurance | 1,861,058 | 1,852,902 |
| Other assets | 10,748,579 | 11,439,419 |
| Total assets | \$1,267,542,353 | \$1,279,698,867 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Deposits: | | |
| Non-interest bearing demand | \$ 123,679,202 | \$ 125,245,200 |
| Savings, interest checking and money market | 360,758,142 | 342,626,702 |
| Time deposits \$100,000 and over | 140,533,958 | 142,972,489 |
| Other time deposits | 366,049,903 | 344,451,998 |
| Total deposits | 991,021,205 | 955,296,389 |
| Federal funds purchased and securities sold under agreements to repurchase | 26,322,121 | 29,138,623 |
| Subordinated notes | 49,486,000 | 49,486,000 |
| Other borrowed money | 83,857,844 | 129,057,483 |
| Accrued interest payable | 3,984,907 | 3,847,415 |
| Other liabilities | 6,548,979 | 6,454,574 |

| | | |
|--|-----------------|-----------------|
| Total liabilities | 1,161,221,056 | 1,173,280,484 |
| Stockholders' equity: | | |
| Preferred stock, \$1000 par value | | |
| Authorized and issued 30,255 shares at March 31, 2009, | 28,007,412 | 27,888,294 |
| Common stock, \$1 par value | | |
| Authorized 15,000,000 shares; issued 4,298,353 shares | 4,298,353 | 4,298,353 |
| Surplus | 25,182,126 | 25,144,323 |
| Retained earnings | 51,432,211 | 51,598,678 |
| Accumulated other comprehensive income, net of tax | 918,013 | 1,005,553 |
| Treasury stock; 161,858 shares, at cost | (3,516,818) | (3,516,818) |
| Total stockholders' equity | 106,321,297 | 106,418,383 |
| Total liabilities and stockholders' equity | \$1,267,542,353 | \$1,279,698,867 |

See accompanying notes to consolidated financial statements.

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

| | For the Three Months Ended March 31, | |
|--|---|-------------------|
| | 2009 | 2008 |
| INTEREST INCOME | | |
| Interest and fees on loans | \$14,444,026 | \$16,461,890 |
| Interest on debt securities: | | |
| Taxable | 1,162,507 | 1,399,518 |
| Nontaxable | 393,616 | 477,500 |
| Interest on federal funds sold and securities purchased under agreements to resell | 150 | 33,960 |
| Interest on interest-bearing deposits | 14,392 | 187 |
| Dividends on equity securities | 19,559 | 52,611 |
| Total interest income | 16,034,250 | 18,425,666 |
| INTEREST EXPENSE | | |
| Interest on deposits: | | |
| Savings, interest checking and money market | 949,950 | 1,549,381 |
| Time deposit accounts \$100,000 and over | 1,080,246 | 1,621,318 |
| Other time deposit accounts | 2,939,881 | 3,551,537 |
| Interest on federal funds purchased and securities sold under agreements to repurchase | 22,487 | 375,381 |
| Interest on subordinated notes | 662,046 | 850,990 |
| Interest on other borrowed money | 849,183 | 932,659 |
| Total interest expense | 6,503,793 | 8,881,266 |
| Net interest income | 9,530,457 | 9,544,400 |
| Provision for loan losses | 1,750,000 | 1,650,000 |
| Net interest income after provision for loan losses | 7,780,457 | 7,894,400 |
| NON-INTEREST INCOME | | |
| Service charges on deposit accounts | 1,377,799 | 1,415,227 |
| Trust department income | 201,647 | 211,756 |
| Gain on sale of mortgage loans, net | 1,020,971 | 251,619 |
| Other | 164,351 | 486,806 |
| Total non-interest income | 2,764,768 | 2,365,408 |
| INVESTMENT SECURITIES GAINS (LOSSES), NET | | 2,773 |
| NON-INTEREST EXPENSE | | |
| Salaries and employee benefits | 4,362,282 | 4,693,719 |
| Occupancy expense, net | 608,277 | 616,104 |

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| | | |
|--|-------------------|---------------------|
| Furniture and equipment expense | 563,658 | 555,618 |
| FDIC insurance assessment | 680,781 | 21,861 |
| Legal, examination, and professional fees | 360,870 | 313,431 |
| Advertising and promotion | 281,271 | 235,610 |
| Postage, printing, and supplies | 284,470 | 287,291 |
| Processing expense | 854,748 | 815,491 |
| Other | 998,375 | 1,105,523 |
| Total non-interest expense | 8,994,732 | 8,644,648 |
| Income before income taxes | 1,550,493 | 1,617,933 |
| Less income taxes | 493,862 | 531,058 |
| Net income | 1,056,631 | 1,086,875 |
| Preferred stock dividends | 493,104 | |
| Net income available to common shareholders | \$ 563,527 | \$ 1,086,875 |
| Basic earnings per share | \$ 0.14 | \$ 0.26 |
| Diluted earnings per share | \$ 0.14 | \$ 0.26 |

See accompanying notes to consolidated financial statements.

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

| | Three months ended March 31, | |
|---|-------------------------------------|---------------------|
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net income | \$ 1,056,631 | \$ 1,086,875 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 1,750,000 | 1,650,000 |
| Depreciation expense | 525,900 | 537,037 |
| Net accretion of debt securities, premiums, and discounts | 84,597 | (41,003) |
| Amortization of intangible assets | 168,543 | 188,994 |
| Stock based compensation expense | 37,803 | 66,987 |
| Decrease in accrued interest receivable | 480,220 | 1,395,735 |
| Increase in cash surrender value -life insurance | (8,156) | (7,245) |
| Decrease (increase) in other assets | 460,862 | (1,380,401) |
| Increase in accrued interest payable | 137,492 | 51,257 |
| Increase in other liabilities | 94,405 | 221,413 |
| Gain on sales of debt securities | | (2,773) |
| Origination of mortgage loans for sale | (51,495,000) | (15,287,729) |
| Proceeds from the sale of mortgage loans | 52,515,971 | 15,539,348 |
| Gain on sale of mortgage loans, net | (1,020,971) | (251,619) |
| Loss on sales and dispositions of premises and equipment | 3,513 | 7,910 |
| Other real estate owned impairment charges | 815,574 | 84,000 |
| (Increase) decrease in deferred tax asset | (55,965) | 487,099 |
| Other, net | 158,846 | 3,926 |
| Net cash provided by operating activities | 5,710,265 | 4,349,811 |
| Cash flows from investing activities: | | |
| Net decrease (increase) in loans | 2,631,238 | (20,015,410) |
| Purchase of available-for-sale debt securities | (36,673,418) | (136,956,490) |
| Proceeds from maturities of available-for-sale debt securities | 31,174,201 | 57,531,407 |
| Proceeds from calls of available-for-sale debt securities | 8,190,000 | 26,232,640 |
| Proceeds from sales of available-for-sale debt securities | | 30,920,778 |
| Purchase of equity securities | | (966,900) |
| Proceeds from sales of equity securities | | 356,500 |
| Purchases of premises and equipment | (166,876) | (337,883) |
| Proceeds from sales of premises and equipment | 36,990 | 27,900 |
| Proceeds from sales of other real estate owned and repossessions | 224,411 | 335,245 |
| Net cash provided by (used) in investing activities | 5,416,546 | (42,872,213) |
| Cash flows from financing activities: | | |
| Net decrease in demand deposits | (1,565,998) | (6,445,199) |
| Net increase in interest-bearing transaction accounts | 18,131,440 | 1,078,276 |
| Net increase in time deposits | 19,159,374 | 901,004 |

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| | | |
|---|----------------------|----------------------|
| Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase | (2,816,502) | 27,024,906 |
| Proceeds from Federal Home Loan Bank advances | | 70,000,000 |
| Repayment of Federal Home Loan Bank advances | (45,199,639) | (56,204,286) |
| Cash dividends paid preferred stock | (235,317) | |
| Cash dividends paid common stock | (868,663) | (875,594) |
| Net cash (used) in provided by financing activities | (13,395,305) | 35,479,107 |
| Net decrease in cash and cash equivalents | (2,268,494) | (3,043,295) |
| Cash and cash equivalents, beginning of year | 53,827,468 | 35,873,385 |
| Cash and cash equivalents, end of period | \$ 51,558,974 | \$ 32,830,090 |

Supplemental disclosures of cash flow information:

Cash paid during the year for:

| | | |
|--------------|--------------|--------------|
| Interest | \$ 6,366,301 | \$ 8,830,006 |
| Income taxes | \$ | \$ |

Supplemental schedule of noncash investing and financing activities:

| | | |
|---|------------|------------|
| Other real estate and repossessions acquired in settlement of loans | \$ 685,000 | \$ 802,313 |
|---|------------|------------|

See accompanying notes to consolidated financial statements.

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

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include all adjustments that, in the opinion of management, are necessary in order to make those statements not misleading. Certain amounts in the 2008 condensed consolidated financial statements have been reclassified to conform to the 2009 condensed consolidated presentation. Such reclassifications have no effect on previously reported net income or stockholders' equity. Operating results for the periods ended March 31, 2009 and 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

These unaudited condensed consolidated interim financial statements should be read in conjunction with our Company's audited consolidated financial statements included in its 2008 Annual Report to Shareholders under the caption "Consolidated Financial Statements" and incorporated by reference into its Annual Report on Form 10-K for the year ended December 31, 2008 as Exhibit 13.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed and omitted. These financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly our Company's consolidated financial position as of March 31, 2009 and the consolidated statements of operations and cash flows for the three-month periods ended March 31, 2009 and 2008.

Fair Value Measurements

Effective January 1, 2008, our Company adopted Statement of Financial Accounting Standard (SFAS) No. 157, *Fair Value Measurement*. SFAS 157 defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. SFAS 157 applies whenever other standards require (permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the Financial Accounting Standards Board (FASB) clarified the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions.

The fair value hierarchy is as follows:

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

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

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

SFAS No. 157 also requires separate disclosure of assets and liabilities measured at fair value on a recurring basis, as documented above, from those measured at fair value on a nonrecurring basis. Nonfinancial assets measured at fair value on a nonrecurring basis would include foreclosed real estate, long-lived assets, and core deposit intangible assets, which are reviewed when circumstances or other events indicate that impairment may have occurred. No circumstances or events happened that indicated impairment may have occurred in the three months ended March 31, 2009; therefore, no measurement at fair value was required for these nonfinancial assets.

In April, 2009 the FASB issued Staff Position SFAS No. 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (SFAS No. 157-4). This position provides guidelines for making fair value measurements more consistent with the principles presented in SFAS No. 157. SFAS No. 157-4 related to determining fair values when there is no active market or where the price inputs being used represent distressed sales. SFAS No. 157-4, which reaffirms SFAS No. 157, states that the objective of fair value measurement is to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. This position will become effective for interim and fiscal years ending after June 15, 2009, with early adoption permitted. Our Company does not expect the adoption of SFAS No. 157-4 to have a material effect on our consolidated financial position or results of operations.

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

Available-for-sale securities

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

Loans

Our Company does not record loans at fair value on a recurring basis other than loans that are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, *Accounting by Creditors for Impairment of a Loan* (SFAS 114). In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. At March 31, 2009, all impaired loans were evaluated based on the fair value of the collateral. The fair value of the collateral is based on an observable market price or current appraised value and therefore, our Company classifies these assets as nonrecurring Level 2. As of March 31, 2009, our Company identified \$32.5 million in impaired loans. These impaired loans had specific allowances for losses aggregating \$4.9 million.

The following table presents information about our Company's assets measured at fair value on a recurring basis as of March 31, 2009, and indicates the fair value hierarchy of the valuation techniques utilized by our Company to determine such fair value.

| Description | Fair Value March 31, 2009 | Fair Value Measurements At March 31, 2009 Using | | |
|-------------------------------|------------------------------|---|--|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available-for-Sale Securities | \$ 146,462,294 | \$ | \$ 146,462,294 | \$ |
| Impaired loans | \$ 27,584,222 | \$ | \$ 27,584,222 | \$ |

Earnings per Share

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the three-month periods ending March 31, 2009 and 2008, respectively. Diluted earnings per share gives effect to all dilutive potential common shares that were outstanding during the three-month periods ending March 31, 2009 and 2008, respectively. The calculations of basic and diluted earnings per share are as follows:

| | For the Three Months Ended March 31, | |
|---|---|-------------|
| | 2009 | 2008 |
| Net income, basic and diluted | \$1,056,631 | \$1,086,875 |
| Less: preferred stock dividends | 493,104 | |
| Net income available to common shareholders | 563,527 | 1,086,875 |
| Average shares outstanding | 4,136,495 | 4,169,495 |
| Effect of dilutive stock options | | 22,771 |
| Average shares outstanding including dilutive stock options | \$4,136,495 | \$4,192,266 |
| Net income per share, basic | \$ 0.14 | \$ 0.26 |
| Net income per share, diluted | 0.14 | 0.26 |

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

The following option to purchase shares during the three months ended 2009 and 2008 were not included in the respective computations of diluted earnings per share because the exercise price of the option, when combined with the effect of the unamortized compensation expense, was greater than the average market price of the common shares and were considered anti-dilutive.

| | 2009 | 2008 |
|----------------------|-------------|-------------|
| Anti-dilutive shares | 262,266 | 25,951 |

Stock-Based Compensation

Our Company's stock option plan provides for the grant of options to purchase up to 450,000 shares of our Company's common stock to officers and other key employees of our Company and its subsidiaries. All options have been granted at exercise prices equal to fair value and vest over periods ranging from four to five years, except 4,821 options issued in 2002, and 9,519 options issued in 2008 to acquire shares that vested immediately.

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

| | Options | Weighted Average Exercise Price | Aggregate Intrinsic Value (000) | Weighted Average Contractual Term (in years) |
|--------------------------------|----------------|--|--|---|
| Outstanding at January 1, 2009 | 266,835 | \$26.10 | | |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | (1,431) | 31.43 | | |
| Canceled | | | | |
| Outstanding at March 31, 2009 | 265,404 | \$26.07 | \$ | 5.7 |
| Exercisable at March 31, 2009 | 190,581 | \$25.50 | \$ | 4.7 |

Total stock-based compensation expense for the three months ended March 31, 2009 and 2008 was \$38,000 and \$67,000, respectively. As of March 31, 2009, the total unrecognized compensation expense related to non-vested stock awards was \$336,000 and the related weighted average period over which it is expected to be recognized is approximately two years.

Comprehensive Income

Comprehensive income for the three-months ended March 31, 2009 and 2008 is summarized as follows:

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2009 | 2008 |
| Net income | \$1,056,631 | \$1,086,875 |
| Other comprehensive income: | | |
| Unrealized gain (loss) on securities: | | |
| Unrealized gain (loss) on debt and equity securities available-for-sale, net of tax | (99,585) | 715,359 |
| Adjustment for (gain) loss on sales and calls of debt and equity securities, net of tax | | (1,692) |
| Defined benefit pension plans: | | |
| Amortization of prior service cost included in net periodic pension cost, net of tax | 12,045 | 3,926 |
| Total other comprehensive income (loss) | (87,540) | 717,593 |
| Comprehensive income | \$ 969,091 | \$1,804,468 |

Goodwill and Intangible Assets

In accordance with SFAS No. 142, our Company's goodwill is tested annually for potential impairment. SFAS No. 142 has a two-step process to test goodwill for impairment. The first step is to compare our Company's estimated

fair value, including goodwill, to its net book value. If the estimated fair value is less than the net book value, a second step is required. Under the second step, the estimated fair value of all our Company's tangible and identifiable intangible net assets must be determined. That amount is compared to our Company's estimated fair value to determine the amount of implied goodwill. Impairment, if any, is equal to the excess of the recorded goodwill over the implied goodwill. During the 2008 annual review, the results of the first step of the process gave

an indication of probable goodwill impairment. This was primarily due to the deterioration of general market conditions experienced during the fourth quarter of 2008 and corresponding declines in our Company's stock price to levels well below book value. In the second step of the process, the implied fair value of our Company's goodwill (determined by comparing the estimated fair value of our Company to the sum of the fair values of our Company's tangible and separately identifiable intangible net assets) was compared with the carrying value of goodwill in order to determine the amount of impairment. As a result of the second step of the process, our Company determined that the goodwill was fully impaired as of December 31, 2008, and recorded an impairment charge of \$40,323,775, before tax in the fourth quarter of 2008.

A summary of goodwill and other intangible assets at and for the three months ended March 31, 2009 and 2008 is as follows:

| | For the Three Months Ended March 31, | | | | | |
|--|---|-------------------------------------|-----------------------|--------------------------------------|-------------------------------------|-----------------------|
| | 2009 | | | 2008 | | |
| | Gross Carrying Amount | Accumulated Amortization | Net Amount | Gross Carrying Amount | Accumulated Amortization | Net Amount |
| Amortizable intangible assets: | | | | | | |
| Core deposit intangible | \$ 7,060,224 | \$(5,098,670) | \$ 1,961,554 | \$ 7,060,224 | \$(4,417,678) | \$ 2,642,546 |
| Mortgage servicing rights | 3,061,142 | (1,540,304) | 1,520,838 | 2,583,979 | (1,422,680) | 1,161,299 |
| Total amortizable intangible assets | 10,121,366 | (6,638,974) | 3,482,392 | 9,644,203 | (5,840,358) | 3,803,845 |
| Goodwill | | | | 40,323,775 | | 40,323,775 |
| Total intangible assets | \$10,121,366 | \$(6,638,974) | \$3,482,392 | \$49,967,978 | \$(5,840,358) | \$44,127,620 |

Changes in the net carrying amount of other intangible assets for the three month period ended March 31, 2009 are shown in the following table:

| | Core Deposit Intangible Asset | Mortgage Servicing Rights |
|----------------------------------|--|--|
| Balance at December 31, 2008 | \$2,130,097 | \$1,171,225 |
| Additions | | 668,239 |
| Amortization | (168,543) | (318,626) |
| Balance at March 31, 2009 | \$1,961,554 | \$1,520,838 |

Mortgage loans serviced for others totaled approximately \$223,348,000 and \$208,378,000 at March 31, 2009 and 2008, respectively.

Our Company's amortization expense on intangible assets in any given period may be different from the estimated amounts depending upon the acquisition of intangible assets, changes in mortgage interest rates, prepayment rates and other market conditions. The following table shows the estimated future amortization expense based on existing asset balances and the interest rate environment as of March 31, 2009 for the next five years:

| | Core Deposit Intangible Asset | Mortgage Servicing Rights |
|------|--|--|
| 2010 | \$526,477 | \$423,000 |
| 2011 | 434,763 | 299,000 |
| 2012 | 408,062 | 236,000 |
| 2013 | 134,684 | 186,000 |
| 2014 | | 146,000 |

The aggregate amortization expense of intangible assets subject to amortization for the three months ended March 31, 2009 and 2008 is as follows:

| | Three Months Ended March 31, | |
|---------------------------------------|---|-------------|
| Aggregate amortization expense | 2009 | 2008 |
| Core deposit intangible asset | \$168,543 | \$188,994 |
| Mortgage servicing rights | 318,626 | 165,247 |

Income Taxes

As of December 31, 2008, our Company had \$749,000 of gross unrecognized tax benefits of which \$487,000 would impact the effective tax rate, if recognized. At March 31, 2009, our Company had \$749,000 of gross unrecognized tax benefits. Our Company expects a reduction \$187,000 in gross unrecognized tax benefits during 2009 as a result of the state statute of limitations closing for the 2005 tax year. Our Company and subsidiaries file income tax returns in the U. S. federal jurisdiction and the state of Missouri.

FASB Interpretation 48, *Accounting for Uncertainty in Accounting in Income Taxes, an Interpretation of FAS No. 109, Accounting for Income Taxes* (FIN 48) provides guidance on disclosure, accrual of interest and penalties, accounting in interim periods, and transition. As of March 31, 2009, interest accrued was approximately \$147,000. Our Company's state and federal income tax returns for 2005 to 2008 are open tax years. As of March 31, 2009, there were no federal or state income tax examinations in process.

Employee Benefit Plans

Employee benefits charged to operating expenses are summarized for the three months ended March 31, 2009 and 2008 in the table below.

| | 2009 | 2008 |
|----------------|-------------|-------------|
| Payroll taxes | \$ 329,300 | \$ 380,841 |
| Medical plans | 370,545 | 364,421 |
| 401k match | 77,730 | 78,084 |
| Pension plan | 228,999 | 218,336 |
| Profit-sharing | 67,175 | 79,478 |
| Other | 21,140 | 30,602 |

| | | |
|-------------------------|-------------|-------------|
| Total employee benefits | \$1,094,889 | \$1,151,762 |
|-------------------------|-------------|-------------|

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

| | Estimated 2009 | Actual 2008 |
|--|---------------------------|------------------------|
| Service cost – benefits earned during the year | \$ 851,000 | \$ 820,401 |
| Interest cost on projected benefit obligations | 509,000 | 452,524 |
| Expected return on plan assets | (523,000) | (454,344) |
| Amortization of prior service cost | 79,000 | 78,628 |
| Amortization of net gains | | (42,802) |
| Net periodic pension expense – Annual | \$ 916,000 | \$ 854,407 |
| Pension expense – three months ended March 31 (actual) | \$ 228,999 | \$ 218,336 |

Our Company made a \$1,500,000 contribution to the defined benefit plan in 2008, and the minimum required contribution for 2009 is estimated to be \$12,000. Our Company has not determined whether it will make any contributions other than the minimum required funding contribution for 2009.

Preferred Stock

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

Participating in this program included our Company's issuance of 30,255 shares of senior preferred stock (with a par value of \$1,000 per share) and a ten year warrant to purchase approximately 245,443 shares of common stock (see below for additional information) to the U.S. Department of Treasury in exchange for \$30,255,000. The proceeds received were allocated between the preferred stock and the common stock warrants based upon their relative fair values. This resulted in the recording of a discount on the preferred stock upon issuance that reflects the value allocated to the warrant. The discount on the preferred stock will be accreted over five years, consistent with management's estimate of the life of the preferred stock. Such accretion will be treated as additional dividends on the preferred stock. The allocated carrying values of the senior preferred stock and common stock warrants at March 31, 2009 were \$28,007,412 and \$2,382,371, respectively.

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

The common stock warrants are exercisable immediately with a ten year term, in whole or in part, at an exercise price of \$18.49 per share. The amount of warrants is reduced by one half if our Company raises equity capital of at least \$30,255,000 by December 31, 2009. The Treasury Department may not exercise or transfer the common stock warrants with respect to more than half of the initial shares of common stock underlying the common stock warrants prior to the earlier of the date on which our Company receives aggregate gross proceeds of not less than \$30,255,000

from one or more qualified equity offerings or before December 31, 2009.

The preferred stock and warrants are classified as permanent equity in the consolidated balance sheets and qualify, for regulatory capital purposes, as Tier I capital. Through March 31, 2009, our Company had declared and paid dividends in the amount of \$235,317 on the preferred stock.

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

Forward-Looking Statements

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

statements that are not historical in nature, and

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

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

competitive pressures among financial services companies may increase significantly,

changes in the interest rate environment may reduce interest margins,

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

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

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

legislative or regulatory changes may adversely affect the business in which Hawthorn and its subsidiaries are engaged, and

changes may occur in the securities markets.

We have described under the caption *Risk Factors* in our Annual Report on Form 10-K for the year ended December 31, 2008, and in other reports that we file with the SEC from time to time, additional factors that could cause actual results to be materially different from those described in the forward-looking statements. Other factors that we have not identified in this report could also have this effect. You are cautioned not to put undue reliance on any forward-looking statement, which speak only as of the date they were made.

Overview

Our Company, Hawthorn Bancshares, Inc., is a community-based, financial institution bank holding company headquartered in Lee's Summit, Missouri. Our Company was incorporated under the laws of the State of Missouri on October 23, 1992 as Exchange National Bancshares, Inc. and changed its name to Hawthorn Bancshares, Inc. in August 2007. Our Company owns all of the issued and outstanding capital stock of Union State Bancshares, Inc., which in turn owns all of the issued and outstanding capital stock of Hawthorn Bank. Our Company conducts operations primarily through our Bank. Our Bank, a state chartered bank, had \$1.26 billion in assets at March 31, 2009, and 25 full-service banking offices, including its principal office in Jefferson City, Missouri. Our Company is committed to providing the most up-to-date financial products and services and delivering these products and services to our market area with superior customer service.

Through our branch network, our Company provides a broad range of commercial and personal banking services, including certificates of deposit, individual retirement and other time deposit accounts, checking and other demand deposit accounts, interest checking accounts, savings accounts, and money market accounts. We also provide a wide range of lending services, including real estate, commercial, installment, and other consumer loans. Other

financial services that we provide include automatic teller machines, trust services, credit related insurance, and safe deposit boxes. The geographic areas in which we provide our products and services include the

communities in and surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee's Summit, Missouri. The products and services are offered to customers primarily within these geographical areas.

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

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

Critical Accounting Policies

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

Allowance for Loan Losses

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

Income Taxes

Our Company accounts for income taxes under the asset / liability method by recognizing the amount of taxes payable or refundable for the current period and deferred tax assets and liabilities for future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in addressing our Company's future tax consequences of events that have been recognized in our consolidated financial statements or tax returns such as realization of the effects of temporary differences, net operating loss carry forwards, and changes in tax laws or interpretations thereof. A valuation allowance is established when in the judgment of management, it is more likely than not that such deferred tax assets will not become realizable. In this case, our Company would adjust the recorded value of our deferred tax asset, which would result in a direct charge to income tax expense in the period that the determination was made. Likewise, our Company would reverse the valuation allowance when the realization of the deferred tax asset is expected. In addition, our Company is subject to the continuous examination of our tax returns by the Internal Revenue Service and other taxing authorities.

Goodwill and Other Intangible Assets

Goodwill represents the excess of costs over fair value of net assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives and reviewed for impairment in accordance with Statement of Financial Accounting Standard (SFAS) No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, our Company performs an annual review of goodwill and intangible assets for impairment to determine whether the carrying value of underlying assets may not be recoverable. Our Company measures recoverability based upon the future cash flows expected to result from the use of the underlying asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying value of the underlying asset, our Company recognizes an impairment loss. The impairment loss recognized represents the amount by which the

carrying value of the underlying asset exceeds the fair value of the underlying asset. As a result of the 2008 annual review, our Company determined that goodwill was fully impaired and recorded an impairment charge of \$40,323,775, before tax. See the notes to the consolidated financial statements (unaudited) for further discussion.

SELECTED CONSOLIDATED FINANCIAL DATA

The following table presents selected consolidated financial information for our Company as of and for each of the three months ended March 31, 2009 and March 31, 2008, respectively. The selected consolidated financial data should be read in conjunction with the Consolidated Financial Statements of our Company, including the related notes, presented elsewhere herein.

Selected Financial Data

| (In thousands, except per share data) | Three Months Ended March 31, | |
|---|---|-------------|
| | 2009 | 2008 |
| Per Share Data | | |
| Basic earnings per common share | \$ 0.14 | \$ 0.26 |
| Diluted earnings per common share | 0.14 | 0.26 |
| Paid on preferred stock | 235 | |
| Amortization of discount on preferred stock | 119 | |
| Paid on common stock | 869 | 876 |
| Book value per common share | 18.93 | 26.91 |
| Market price | 11.75 | 27.54 |

Selected Ratios

(Based on average balance sheets)

| | | |
|---|-------|-------|
| Return on average total assets | 0.34% | 0.36% |
| Return on average common stockholders' equity | 2.88% | 3.89% |
| Average common stockholders' equity to average total assets | 6.28% | 9.20% |

(Based on end-of-period data)

| | | |
|---|--------|--------|
| Efficiency ratio (1) | 73.16% | 72.59% |
| Period-end common stockholders' equity to period-end assets | 6.18% | 9.10% |
| Period-end tangible common stockholders' equity to period-end tangible assets | 5.92% | 5.72% |
| Period-end stockholders' equity to period-end assets | 8.39% | 9.10% |
| Total risk-based capital ratio | 16.22 | 13.17 |
| Tier 1 risk-based capital ratio | 13.70 | 11.00 |
| Leverage ratio | 11.02 | 8.87 |

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

**Results of Operations
Summary**

| <i>(Dollars in thousands)</i> | Three Months Ended March 31, | | | % Change |
|--|---|-----------------|----------------------|---------------------|
| | 2009 | 2008 | \$ Change | |
| Net interest income | \$ 9,530 | \$ 9,545 | \$ (15) | (0.2)% |
| Provision for loan losses | 1,750 | 1,650 | 100 | 6.1 |
| Noninterest income | 2,765 | 2,365 | 400 | 16.9 |
| Investment securities gains, net | | 3 | (3) | (100.0) |
| Noninterest expense | 8,995 | 8,645 | 350 | 4.0 |
| Income (loss) before income taxes | 1,550 | 1,618 | (68) | (4.2) |
| Income taxes | 493 | 531 | (38) | (7.2) |
| Net income | \$ 1,057 | \$ 1,087 | \$ (30) | (2.8)% |
| Less: preferred dividends | 493 | | 493 | |
| Net income available to common shareholders | \$ 564 | \$ 1,087 | \$ (523) | (48.1)% |

Our Company's consolidated net income of \$1,057,000 for the first quarter of 2009 was essentially unchanged when compared to \$1,087,000 for the first quarter of 2008. \$493,000 of the first quarter income was restricted for preferred shareholders, resulting in \$564,000 of net income available to common shareholders, or \$.14 per diluted common share, compared to \$1,087,000, or \$.26 per diluted common share for the first quarter ended March 31, 2008. For the first three months of 2009, the annualized return on average assets was 34 basis points, the annualized return on average common shareholders' equity was 2.88%, and the efficiency ratio was 73.2%. Our Company did experience substantial real estate refinancing activity in the first quarter of 2009, which contributed an additional \$800,000 to income. However, this was offset by an industry wide increase in FDIC insurance assessments as well as an increase in our provision for loan losses. Net interest margin decreased 23 basis points from 3.55% to 3.32%. Net interest income, on a tax equivalent basis, decreased \$46,000 or 47 basis points from 2008 to 2009. Total assets at March 31, 2009 were \$1,267,542,000, compared to \$1,279,698,000 at March 31, 2008, a decrease of \$12,156,000, or 1.0%.

Net Interest Income

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

Average Balance Sheets

The following table presents average balance sheets, net interest income, average yields of earning assets, average costs of interest bearing liabilities, net interest spread and net interest margin on a fully taxable equivalent basis for each of the three month periods ended March 31, 2009 and March 31, 2008, respectively.

| (dollars in thousands) | Three Months Ended March 31, | | | | | |
|--|-------------------------------------|-------------------|----------------|---------------------|-------------------|----------------|
| | 2009 | 2009 | Rate | 2008 | 2008 | Rate |
| | Average | Interest | Earned/ | Average | Interest | Earned/ |
| | Balance | Income/ | Paid(1) | Balance | Income/ | Paid(1) |
| | | Expense(1) | | | Expense(1) | |
| ASSETS | | | | | | |
| Loans: (2) (4) | \$ 1,010,167 | \$ 14,467 | 5.81% | \$ 917,800 | \$ 16,487 | 7.21% |
| Investment in securities: (3) | | | | | | |
| Government sponsored enterprises | 108,795 | 1,143 | 4.26 | 123,844 | 1,381 | 4.47 |
| State and municipal | 41,828 | 586 | 5.68 | 51,099 | 698 | 5.48 |
| Other | 8,875 | 20 | 0.91 | 6,252 | 53 | 3.40 |
| Federal funds sold | 451 | | | 4,573 | 34 | 2.98 |
| Interest bearing deposits in other financial institutions | 17,604 | 14 | 0.32 | 124 | | |
| Total interest earning assets | 1,187,720 | 16,230 | 5.54 | 1,103,692 | 18,653 | 6.78 |
| All other assets | 88,750 | | | 126,890 | | |
| Allowance for loan losses | (12,729) | | | (9,435) | | |
| Total assets | \$ 1,263,741 | | | \$ 1,221,147 | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | |
| NOW accounts | \$ 143,674 | \$ 336 | 0.95% | \$ 115,138 | \$ 373 | 1.30% |
| Savings | 44,391 | 36 | 0.33 | 43,266 | 58 | 0.54 |
| Money market | 177,300 | 578 | 1.32 | 174,142 | 1,117 | 2.57 |
| Time deposits of \$100,000 and over | 138,539 | 1,080 | 3.16 | 142,880 | 1,622 | 4.55 |
| Other time deposits | 356,812 | 2,940 | 3.34 | 313,988 | 3,552 | 4.54 |
| Total time deposits | 860,716 | 4,970 | 2.34 | 789,414 | 6,722 | 3.42 |
| Federal funds purchased and securities sold under agreements to repurchase | 29,344 | 23 | 0.32 | 51,894 | 375 | 2.90 |
| Subordinated notes | 49,486 | 662 | 5.43 | 49,486 | 851 | 6.90 |

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| | | | | | | |
|--|-------------|----------|-------|-------------|----------|-------|
| Other borrowed money | 89,037 | 849 | 3.87 | 90,053 | 933 | 4.16 |
| Total interest bearing liabilities | 1,028,583 | 6,504 | 2.56 | 980,847 | 8,881 | 3.63 |
| Demand deposits | 118,620 | | | 118,944 | | |
| Other liabilities | 9,267 | | | 8,962 | | |
| Total liabilities | 1,156,470 | | | 1,108,753 | | |
| Stockholders equity | 107,271 | | | 112,394 | | |
| Total liabilities and stockholders equity | \$1,263,741 | | | \$1,221,147 | | |
| Net interest income (FTE) | | \$ 9,726 | | | \$ 9,772 | |
| Net interest spread | | | 2.98% | | | 3.15% |
| Net interest margin | | | 3.32% | | | 3.55% |

(1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 35%, net of nondeductible interest expense. Such adjustments totaled \$196,000 and \$228,000 for the three months ended March 31, 2009 and 2008, respectively.

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

(3) Average balances based on amortized cost.

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

Comparison of the three months ended March 31, 2009 and 2008

Financial results for the first three months of 2009 compared to 2008 included a decrease in net interest income, on a tax equivalent basis of \$46,000, or 47 basis points. Average interest-earning assets increased \$84,028,000, or 7.6% to \$1,187,720,000 at March 31, 2009 compared to \$1,103,692,000 at March 31, 2008, but was offset by a decrease in net interest margin and a higher provision for loan loss.

Average loans outstanding increased \$92,367,000 or 10.1% to \$1,010,167,000 for first three months of 2009 compared to \$917,800,000 for 2008. Average commercial loans outstanding decreased approximately \$1,127,000 or 74 basis points for 2009 compared to 2008. Average real estate loans outstanding increased approximately \$95,157,000 or 13.0% for 2009 compared to 2008. Average consumer loans outstanding decreased approximately \$1,663,000 or 4.8% for 2009 compared to 2008. See the Lending and Credit Management section of this discussion for further discussion of changes in the composition of our lending portfolio.

Average investment securities and federal funds sold decreased \$25,819,000 or 13.9% to \$189,949,000 at March 31, 2009 compared to \$185,768,000 for 2008. The decrease in average investment securities during 2009 and 2008 reflects the use of investment liquidity to fund our Company's growth in the loan portfolio.

Average interest bearing liabilities increased \$47,736,000, or 4.8%, to \$1,028,583,000 at March 31, 2009 compared to \$980,847,000 at March 31, 2008. Average time deposits increased \$71,617,000 or 9.0% to \$860,716,000 for 2009 compared to \$789,414,000 for 2008. The increase was primarily a result of increased public fund deposits and customers increasing savings in light of the current economy. Product specials promoting interest bearing checking accounts and certificate of deposits contributed to the increase in new deposits.

Average federal funds purchased and securities sold under agreements to repurchase decreased \$22,550,000 or 43.4% to \$29,344,000 for 2009 compared to \$51,894,000 for 2008. This primarily is a result of a \$24,000,000 decrease in a public fund term repurchase agreement and a \$4,000,000 decrease in federal funds purchased during the first three months of 2008 compared to 2009. Average other borrowed money decreased \$1,016,000 or 1.1% to \$89,037,000 for 2009 compared to \$90,053,000 for 2008. The decrease in 2009 reflects a net decrease in Federal Home Loan Bank advances.

Rate and volume analysis

The following table summarizes the changes in net interest income on a fully taxable equivalent basis, by major category of interest earning assets and interest bearing liabilities, indentifying changes related to volumes and rates for the three months ended March 31, 2009 compared to March 31, 2008. 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.

| <i>(Dollars In thousands)</i> | Three Months Ended March 31, 2009 vs. 2008 | | |
|--|---|---------------------------|---|
| | Total Change | Average Volume | Change due to Average Rate |
| Interest income on a fully taxable equivalent basis: | | | |
| Loans: (1) (3) | \$(2,020) | \$1,548 | \$(3,568) |
| Investment securities: | | | |
| Government sponsored entities | (238) | (161) | (77) |
| State and municipal(2) | (112) | (130) | 18 |
| Other | (33) | 16 | (49) |
| Federal funds sold | (34) | (16) | (18) |
| Interest bearing deposits in other financial institutions | 14 | | 14 |
| Total interest income | (2,423) | 1,257 | (3,680) |
| Interest expense: | | | |
| NOW accounts | (37) | 80 | (117) |
| Savings | (22) | 2 | (24) |
| Money market | (539) | 20 | (559) |
| Time deposits of 100,000 and over | (542) | (48) | (494) |
| Other time deposits | (612) | 440 | (1,052) |
| Federal funds purchased and securities sold under agreements to repurchase | (352) | (115) | (237) |
| Subordinated notes | (189) | | (189) |
| Other borrowed money | (84) | (11) | (73) |
| Total interest expense | (2,377) | 368 | (2,745) |
| Net interest income on a fully taxable equivalent basis | \$ (46) | \$ 889 | \$ (935) |

(1) Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 35%, net of nondeductible interest expense. Such adjustments totaled \$196,000 and \$228,000 for the three months ended March 31, 2009 and 2008, respectively.

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

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

Net interest income on a fully taxable equivalent basis decreased \$46,000 or 47 basis points to \$9,726,000 for the first three months of 2009 compared to \$9,772,000 for 2008. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) decreased from 3.55% for the first three months of

2008 to 3.32% for 2009. Although our Company's loan growth remains strong, the current economic conditions continue to narrow the net interest spread as seen from the decrease to 2.98% in 2009 from 3.15% in 2008.

While our Company was able to decrease the rate paid on interest bearing liabilities to 2.56% in the first three months of 2009 versus 3.63% in 2008, this decrease was offset by a decrease in the rates earned on interest bearing assets from 6.78% during the first three months of 2008 to 5.54% in 2009.

Provision for loan losses

The provision for loan losses for 2009 was \$1,750,000 compared to \$1,650,000 for 2008. Loans charged off, net of recoveries, for 2009 were \$1,257,000 compared to \$924,000 for 2008. Approximately \$117,000 of the 2009 net charge-offs represents various commercial loan losses, \$476,000 represents real estate construction losses, \$646,000 represents real estate mortgage loan losses, and approximately \$18,000 represents various consumer loan losses.

Further discussion of management's methodology related to the allowance and provision for loan losses may be found in the Lending and Credit Management section of this report.

Non-interest Income and Expense**Non-interest income**

| <i>(Dollars in thousands)</i> | 2009 | 2008 | Three Months Ended March 31, \$ Change | % Change |
|--|----------------|----------------|---|-----------------|
| Non-interest Income | | | | |
| Service charges on deposit accounts | \$1,378 | \$1,415 | \$ (37) | (2.6)% |
| Trust department income | 202 | 212 | (10) | (4.7) |
| Gains on sales of mortgage loans | 1,021 | 252 | 769 | 305.2 |
| Other | 164 | 486 | (322) | (66.3) |
| Total non-interest income | \$2,765 | \$2,365 | \$ 400 | 16.9% |
| Investment securities gains (losses), net | \$ | \$ 3 | \$ (3) | (100.0)% |
| Non-interest income as a % of total revenue * | 22.5% | 19.9% | | |
| Total revenue per full-time equivalent employee | \$ 54.6 | \$ 60.6 | \$ | |

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

Three Months Ended March 31, 2009 and 2008

Non-interest income for the first three months ended March 31, 2009 was \$2,765,000 compared to \$2,365,000 in the first three months of 2008, resulting in a \$400,000, or 16.9%, increase. Gains on sales of mortgage loans increased \$769,000, or 305.2%, as a result of increased refinancing activity. Our Company was servicing \$223,348,000 of mortgage loans at March 31, 2009 compared to \$208,378,000 at March 31, 2008. Other income decreased \$322,000, or 66.3%, to \$164,000 compared to the prior period, primarily due to a \$114,000 recovery of legal and collection costs in the first quarter of 2008, a \$153,000 increase in amortization of mortgage loan servicing rights, and a \$68,000 decrease in brokerage and credit card income.

Non-interest expense

| <i>(Dollars in thousands)</i> | Three Months Ended March 31, | | | % Change |
|--|---|----------------|------------------|---------------------|
| | 2009 | 2008 | \$ Change | |
| Non-interest Expense | | | | |
| Salary expense | \$3,267 | \$3,542 | \$(275) | (7.8)% |
| Employee benefits | 1,095 | 1,152 | (57) | (4.9) |
| Occupancy expense, net | 608 | 616 | (8) | (1.3) |
| Furniture and equipment expense | 564 | 557 | 7 | 1.3 |
| FDIC insurance assessment | 681 | 22 | 659 | NM |
| Legal, examination, and professional fees | 361 | 313 | 48 | 15.3 |
| Advertising and promotion | 281 | 235 | 46 | 19.6 |
| Postage, printing, and supplies | 284 | 287 | (3) | (1.0) |
| Processing expense | 855 | 815 | 40 | 4.9 |
| Other | 999 | 1,106 | (107) | (9.7) |
| Total non-interest expense | \$8,995 | \$8,645 | \$ 350 | 4.0% |
| Efficiency ratio | 73.2% | 72.6% | | |
| Salaries and benefits as a % of total non-interest expense | 48.5% | 54.3% | | |
| Number of full time equivalent employees | 344 | 343 | | |

Three Months Ended March 31, 2009 and 2008

Non-interest expense for the first three months ended March 31, 2009 was \$8,995,000 compared to \$8,645,000 in the first three months of 2008, resulting in a \$350,000, or 4.0%, increase. Salary expense decreased \$275,000, or 7.8%, employee benefits decreased \$57,000, or 4.9%, FDIC insurance assessment increased \$659,000, legal and professional fees increased \$48,000, or 15.3%, and advertising and promotion expense increased \$46,000, or 19.6%. The \$275,000 decrease in salary expense primarily reflects a \$143,000 decrease in salaries, a \$85,000 reduction in incentive compensation expense, and a \$29,000 decrease in stock option compensation expense. The \$57,000 decrease in employee benefits primarily represents reductions in profit-sharing expense as a result of lower earnings. The \$659,000 increase in the FDIC insurance assessment is a result of higher assessment rates in effect for the current year as well as the depletion of the Bank's one-time FDIC assessment credit. The \$46,000 increase in advertising and promotion reflects a \$65,000 net increase in advertising costs and a \$19,000 decrease in promotional costs. Our Company's marketing projects began during the first quarter of 2009 in comparison to the second quarter of 2008 resulting in a \$73,000 increase in advertising expenses.

Income taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 31.9% for the first three months of 2009 compared to 32.8% for 2008. The decrease in the effective tax rate for 2009 is due to an increase in non-taxable income as a percentage of total income in the current year.

Lending and Credit Management

Interest earned on the loan portfolio is a primary source of interest income for our Company. Net loans represented 78.2% of total assets as of March 31, 2009 compared to 77.8% as of December 31, 2008.

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

senior loan committee meets weekly and is comprised of senior managers of the Bank.

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

| <i>(In thousands)</i> | March 31, | | December 31, | |
|---|--------------------|---------------|---------------------|---------------|
| | 2009 | % | 2008 | % |
| Commercial, financial, and agricultural | \$ 152,204 | 15.2% | \$ 153,386 | 15.2% |
| Real estate Construction | 115,557 | 12.9 | 129,639 | 12.8 |
| Real estate Mortgage | 706,285 | 70.3 | 692,530 | 68.6 |
| Installment loans to individuals | 30,484 | 3.0 | 33,548 | 3.3 |
| Total loans | \$1,004,530 | 100.0% | \$1,009,103 | 100.0% |

Our Company's loan portfolio decreased \$4,573,000 or 50 basis points from December 31, 2008 to March 31, 2009. Real estate mortgage loans increased \$13,755,000 or 2.0% due to low interest rates and an increase in refinancing. Offsetting this increase was a decrease in commercial loans of \$1,182,000 or 8 basis points, a decrease in real estate construction loans of \$14,082,000 or 10.9%, and a decrease in individual consumer loans of \$3,064,000 or 9.1%. The demand for commercial real estate loans remained relatively strong in most of the regions our Company serves. Although management tightened underwriting standards during the year, our Company continued to find opportunities to lend to credit worthy borrowers with the capacity to service the debts. This growth was not centered in any one industry, region or borrower and included a fairly diversified portfolio of loans ranging from owner occupied and regional retail properties to include some hospitality properties. Our growth in real estate loans was also partially the result of loans moving from construction to amortizing loans, thus contributing to the decrease in our construction portfolio. In addition, the decrease in lending activities in the real estate construction market also reflects the slow down in the housing industry and residential construction industry as well as foreclosures on various residential construction properties. Construction lending will continue to be closely monitored during 2009.

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

Our Company generally does not retain long-term fixed rate residential mortgage loans in its portfolio. Fixed rate loans conforming to standards required by the secondary market are offered to qualified borrowers, but are not funded until our Company has a non-recourse purchase commitment from the secondary market at a predetermined price. At March 31, 2009 our Company was servicing approximately \$223,000,000 of loans sold to the secondary market.

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

The provision for loan losses is based on management's evaluation of the loan portfolio in light of national and local economic conditions, changes in the composition and volume of the loan portfolio, changes in the volume of past due and nonaccrual loans, the value of underlying collateral and other relevant factors. The allowance for loan losses which is reported as a deduction from loans is available for loan charge-offs. This allowance is increased by the provision charged to expense and is reduced by loan charge-offs net of loan recoveries.

Management, through the establishment of a senior loan committee, formally reviews all loans in excess of certain dollar amounts (periodically established) at least annually. Currently, loans in excess of \$2,000,000 in aggregate and all adversely classified credits identified by management as containing more than usual risk are reviewed. On a monthly basis, the senior loan committee reviews and reports to the Board of Directors past due, classified, and watch list loans in order to classify or reclassify loans as loans requiring attention, substandard, doubtful, or loss. During review, management also determines which loans should be considered impaired. Management follows the guidance provided in Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, (SFAS 114) 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. Once a loan has been identified as impaired management generally measures impairment based upon the fair value of the underlying collateral. Management believes, but there can be no assurance, that these procedures keep management informed of possible problem loans. Based upon these procedures, both the allowance and provision for loan losses are adjusted to maintain the allowance at a level considered adequate by management for probable losses inherent in the loan portfolio.

Allowance for Loan Losses

The provision for loan losses increased \$100,000 or 6.1% to \$1,750,000 for 2009 compared to \$1,650,000 for 2008. The provision reflects the amounts management determined necessary to maintain the allowance for loan losses at a level that was adequate to cover probable losses in the loan portfolio. The allowance for loan losses totaled \$13,159,000 or 1.3% of loans outstanding at March 31, 2009 compared to \$12,667,000 or 1.2% of loans outstanding at December 31, 2008. The allowance for loan losses expressed as a percentage of nonperforming loans was 44.7% at March 31, 2009 and 50.9% at December 31, 2008.

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

| <i>(Dollars in thousands)</i> | Three Months Ended March 31, | |
|---|---|-------------|
| | 2009 | 2008 |
| Provision for loan losses | 1,750 | 1,650 |
| Net loan charge-offs: | | |
| Commercial, financial, and agricultural | 117 | 816 |
| Real estate construction | 476 | (17) |
| Real estate mortgage | 646 | 63 |
| Installment loans to individuals | 18 | 62 |
| Total net loan charge-offs | 1,257 | 924 |

The increased provision for loan losses was the result of an increased level of charged-off loans and an increase in the level of nonperforming loans. As shown in the table above, our Company experienced net loan charge-offs of \$1,257,000 during the first quarter of 2009 and \$924,000 during the first quarter of 2008.

Nonperforming loans, defined as loans on nonaccrual status, loans 90 days or more past due, and restructured loans totaled \$29,406,000 or 2.93% of total loans at March 31, 2009 compared to \$24,866,000 or 2.46% of total loans at December 31, 2008. The following table summarizes our Company's nonperforming assets at the dates indicated:

| <i>(Dollars in thousands)</i> | March 31, 2009 | December 31, 2008 |
|---|---------------------------|------------------------------|
| Nonaccrual loans: | | |
| Commercial, financial, and agricultural | \$ 1,923 | \$ 2,071 |
| Real estate construction | 11,931 | 10,347 |
| Real estate mortgage | 9,037 | 7,850 |
| Installment loans to individuals | 126 | 119 |
| Total nonaccrual loans | 23,017 | 20,387 |
| Loans contractually past due 90 days or more and still accruing: | | |
| Commercial, financial, and agricultural | 971 | 140 |
| Real estate construction | | 52 |
| Real estate mortgage | 1,663 | 547 |
| Installment loans to individuals | 19 | 4 |
| Total loans contractually past -due 90 days or more and still accruing | 2,653 | 743 |
| Restructured troubled loans | 3,736 | 3,736 |
| Total nonperforming loans | 29,406 | 24,866 |
| Other real estate | 7,473 | 7,828 |
| Total nonperforming assets | \$ 36,879 | \$ 32,694 |
| Loans | \$1,004,530 | 1,009,103 |
| Allowance for loan losses to loans | 1.31% | 1.26% |
| Nonperforming loans to loans | 2.93% | 2.46% |
| Allowance for loan losses to nonperforming loans | 44.75% | 50.94% |
| Nonperforming assets to loans and foreclosed assets | 3.64% | 3.21% |

It is our Company's policy to discontinue the accrual of interest income on loans when the full collection of principal or interest is in doubt, or when the payment of principal or interest has become contractually 90 days past due unless the obligation is both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectibles of such principal; otherwise, such receipts are recorded as interest income. Interest on nonaccrual loans, which would have been recorded under the original terms of the loans, was approximately \$321,000 and \$152,000 for the three months ended March 31, 2009 and 2008, respectively. Approximately \$3,000 and \$29,000 was recorded as interest income on such loans for the three months ended March 31, 2009 and 2008, respectively.

Total non-accrual loans at March 31, 2009 increased \$2,630,000 from December 31, 2008. The increase resulted primarily from an increase of \$1,584,000 in real estate construction non-accrual loans and an increase of \$1,187,000 in real estate mortgage non-accrual loans. Foreclosed real estate decreased \$355,000 to \$7,473,000 and there was no change in restructured loans at March 31, 2009 in comparison to December 31, 2008. Loans past due 90 days and still accruing interest increased \$1,910,000 from December 31, 2008 to March 31, 2009. This increase primarily represents two commercial customers with balances totaling \$1,888,000. These loans are in the process of being renewed and

brought current.

Our Company has experienced an increase in its loan delinquencies much like the rest of the banking industry as current economic conditions negatively impact our borrowers' ability to keep their debt payments current. Management believes close monitoring of these credits will mitigate potential higher delinquency levels and/or losses. Management believes these loans are well secured and is actively focused on managing and collecting these accounts to prevent further deterioration.

A loan is considered impaired when it is probable a creditor will be unable to collect all amounts due both principal and interest according to the contractual terms of the loan agreement. In addition to nonaccrual loans at March 31, 2009 included in the table above, which were considered impaired, management has identified additional loans totaling approximately \$9,538,000 which are not included in the nonaccrual table above but are considered by management to be impaired compared to \$9,546,000 at December 31, 2008. The balance of impaired loans with no specific loan loss allocation was approximately \$5,783,000 at March 31, 2009, compared to \$11,452,000 at December 31, 2008.

Once a loan has been identified as impaired, as defined by paragraph 8 of SFAS 114, *Accounting by Creditors for Impairment of a Loan*, management generally measures impairment based upon the fair value of the underlying collateral. In general, market prices for loans in our portfolio are not available, and we have found the fair value of the underlying collateral to be more readily available and reliable than discounting expected future cash flows to be received. Once a fair value of collateral has been determined and the impairment amount calculated, a specific reserve allocation is made. At March 31, 2009, \$4,971,000 of our Company's allowance for loan losses was allocated to impaired loans totaling approximately \$32,555,000.

As of March 31, 2009 and December 31, 2008 approximately \$17,191,000 and \$13,389,000, respectively, of loans not included in the nonaccrual table above or identified by management as being impaired were classified by management as having more than normal risk which raised doubts as to the ability of the borrower to comply with present loan repayment terms. The \$3,802,000 increase in classified loans is the result of several borrowers who have experienced cash flow problems as well as some deterioration in collateral value. Management elected to allocate non-specific reserves to these credits based upon the inherent risk present. This increase in reserves was the result of our Company's internal loan review process which assesses credit risk. In addition to the classified list, our Company also maintains an internal loan watch list of loans which for various reasons, not all related to credit quality, management is monitoring more closely than the average loan in the portfolio. Loans may be added to this list for reasons which are temporary and correctable, such as the absence of current financial statements of the borrower, or a deficiency in loan documentation. Other loans are added as soon as any problem is detected which might affect the borrower's ability to meet the terms of the loan. This could be initiated by the delinquency of a scheduled loan payment, deterioration in the borrower's financial condition identified in a review of periodic financial statements, a decrease in the value of the collateral securing the loan, or a change in the economic environment within which the borrower operates. Once a loan is placed on our Company's watch list, its condition is monitored closely. Any further deterioration in the condition of the loan is evaluated to determine if the loan should be assigned to a higher risk category.

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

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

The expected loss component is generally determined by applying percentages to pools of loans by asset type. These pre-established percentages are based upon standard bank regulatory classification percentages as well as average historical loss percentages. These expected loss estimates are sensitive to changes in delinquency status, realizable value of collateral, and other risk factors.

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

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

At March 31, 2009, management allocated \$12,386,000 of the \$13,159,000 total allowance for loan losses to specific loans and loan categories and \$773,000 was unallocated. At December 31, 2008, management allocated \$11,163,000 of the \$12,666,000 total allowance for loan losses to specific loans and loan categories and \$1,503,000 was unallocated. Considering the size of several of our Company's lending relationships and the loan portfolio in total, management believes that the March 31, 2009 allowance for loan losses is adequate.

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

Financial Condition

Total assets decreased \$12,156,000 or 1.0% to \$1,267,542,000 at March 31, 2009 compared to \$1,279,699,000 at December 31, 2008. Earning assets at March 31, 2009 were \$1,193,000 and consisted of 84.2% in loans and 12.3% in available for sale investment securities, compared to 84.2% and 12.5%, respectively at December 31, 2008. Total liabilities decreased \$12,059,000 or 1.0% to \$1,161,221,000 compared to \$1,173,280,000 at December 31, 2008. Stockholders' equity decreased \$97,000 or 0.1% to \$106,321,000 compared to \$106,418,000 at December 31, 2008.

As described in further detail in the Lending and Credit Management section above, during the first three months of 2009, total period end loans decreased \$4,573,000 to \$1,004,530,000 at March 31, 2009 compared to \$1,009,103,000 at December 31, 2008. This decrease was primarily the result of a \$14,082,000 decrease in construction loans, and a \$3,064,000 decrease in consumer loans offset by a \$13,755,000 increase in real estate mortgage loans.

Investment in debt securities classified as available-for-sale, excluding fair value adjustments, decreased \$2,775,000 or 1.9% to \$143,246,000 at March 31, 2009 compared to \$146,021,000 at December 31, 2008. The net decrease consisted of an increase in mortgage-backed securities totaling \$12,126,000, offset by a \$9,596,000 and \$5,305,000 reduction in federal agency securities and municipal obligations, respectively. Investment in equity securities of \$8,875,000 did not change from December 31, 2008 to March 31, 2009.

Although all securities, except equity securities, are classified as available-for-sale and have on occasion been sold prior to maturity to meet liquidity needs or to improve portfolio yields, management has the ability and intent to hold securities until maturity and expects that the securities will be redeemed at par. Therefore management does not consider any of the securities, with fair value less than amortized cost, to be other than temporarily impaired.

Total deposits increased \$35,725,000 or 3.7% to \$991,021,000 at March 31, 2009 compared to \$955,296,000 at December 31, 2008. The increase is primarily a result of an increase in public fund deposits and customers trending towards saving more in light of the current economy.

Federal funds purchased and securities sold under agreements to repurchase decreased \$2,816,000 or 9.7% to \$26,322,000 at March 31, 2009 compared to \$29,139,000 at December 31, 2008. The decrease is a result of a \$3,000,000 term repurchase agreement maturing during the first three months of 2009.

Other borrowed money decreased \$45,200,000 or 35.0% to \$83,858,000 at March 31, 2009 compared to \$129,057,000 at December 31, 2008. The decrease reflects the repayment of Federal Home Loan Bank advances. There were no new Federal Home Loan Bank advances during the first three months of 2009.

Stockholders' equity decreased \$97,000 or 0.1% to \$106,321,000 at March 31, 2009 compared to \$106,418,000 at December 31, 2008. The decrease in stockholders' equity reflects net income of \$1,056,000 less dividends declared of \$1,104,000, a \$99,000 change in unrealized holding gains, net of taxes, on investment in debt securities available-for-sale, \$12,000 amortization of prior service cost for defined benefit plan, and a \$38,000 increase, net of taxes, related to stock option compensation expense.

No material changes in our Company's liquidity or capital resources have occurred since March 31, 2009.

Liquidity and Capital Resources

Liquidity Management

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

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

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

| <i>(dollars in thousands)</i> | March 31, 2009 | December 31, 2008 |
|---|---------------------------|------------------------------|
| Liquid assets: | | |
| Federal funds sold | \$ 116 | \$ 104 |
| Available for sale investments securities | 146,462 | 149,401 |
| Total | 146,578 | 149,505 |

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 \$146,462,000 at March 31, 2009 and included an unrealized net gain of \$3,216,000. The portfolio includes maturities of approximately \$28,329,000 over the next twelve months, which offer resources to meet either new loan demand or reductions in our Company's deposit base. Our Company pledges portions of its investment securities portfolio to secure public fund deposits, securities sold under agreements to repurchase, trust funds, and borrowing capacity at the Federal Reserve Bank. At March 31, 2009, total investment securities pledged for these purposes were as follows:

| <i>(dollars in thousands)</i> | March 31, 2009 |
|---|---------------------------|
| Investment securities pledged for the purpose of securing: | |
| Federal Reserve Bank borrowings | \$ 3,330 |
| Repurchase agreements | 32,229 |
| Other Deposits | 90,687 |
| Total pledged, at fair value | 126,246 |

At March 31, 2009, our Company's unpledged securities in the available for sale portfolio totaled approximately \$20,216,000.

Liquidity is also available from our Company's base of core customer deposits, defined as demand, interest, checking, savings, and money market deposit accounts. At March 31, 2009, such deposits totaled \$484,437,000 and represented 48.9% of our Company's total deposits. These core deposits are normally less volatile and are often tied to other products of our Company through long lasting relationships. Time deposits and certificates of deposit of \$100,000 and over totaled \$506,584,000 at March 31, 2009. These accounts are normally considered more volatile and higher costing representing 51.1% of total deposits at March 31, 2009.

| <i>(dollars in thousands)</i> | March 31, 2009 | December 31, 2008 |
|-------------------------------|---------------------------|------------------------------|
| Core deposit base: | | |
| Non-interest bearing demand | \$ 123,679 | \$ 125,245 |
| Interest checking | 139,605 | 123,289 |
| Savings and money market | 221,153 | 219,338 |
| Total | 484,437 | 467,872 |

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

| <i>(dollars in thousands)</i> | March 31, 2009 | December 31, 2008 |
|--|---------------------------|------------------------------|
| Borrowings: | | |
| Securities sold under agreements to repurchase | \$ 26,322 | \$ 29,139 |
| FHLB advances | 83,858 | 129,057 |
| Subordinated notes | 49,486 | 49,486 |
| Total | 159,666 | 207,682 |

Federal funds purchased are overnight borrowings obtained mainly from upstream correspondent banks with which our Company maintains approved credit lines. As of March 31, 2009, under agreements with these unaffiliated banks, the Bank may borrow up to \$45,000,000 in federal funds on an unsecured basis and \$11,000,000 on a secured basis. There were no federal funds purchased outstanding at March 31, 2009. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of our Company's investment portfolio. At March 31, 2009 there was \$26,322,000 in repurchase agreements. Our Company may periodically borrow additional short-term funds from the Federal Reserve Bank through the discount window; although no such borrowings were outstanding at the current quarter end. The Bank is a member of the Federal Home Loan Bank of Des Moines (FHLB). As a member of the FHLB, the Bank has access to credit products of the FHLB. As of March 31, 2009, the Bank had \$83,859,000 in outstanding borrowings with the FHLB. In addition, our Company has \$49,486,000 in outstanding subordinated notes issued to wholly-owned grantor trusts, funded by preferred securities issued by the trusts.

Our Company pledges certain assets, including loans and investment securities to the Federal Reserve Bank, FHLB, and other correspondent banks as security to establish lines of credit and borrow from these entities. Based on the type and value of collateral pledged, our Company may draw advances against this collateral. The following table reflects collateral value of assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to our Company at March 31, 2009:

| <i>(dollars in thousands)</i> | March 31, 2009 | | |
|-------------------------------|-----------------------|------------------------|--------------|
| | FHLB | Federal Reserve | Other |
| Collateral value pledged | \$ 329,350 | \$ 3,459 | \$ 9,770 |
| Advances outstanding | (83,858) | | (2,095) |
| Letters of credit issued | (100) | | |

| | | | |
|--------------|---------|-------|-------|
| Total | 245,392 | 3,459 | 7,675 |
|--------------|---------|-------|-------|

Sources and Uses of Funds

Cash and cash equivalents was \$51,559,000 at March 31, 2009 compared to \$53,827,000 at December 31, 2008. The \$2,268,000 decrease resulted from changes in the various cash flows produced by operating, investing, and financing activities of our Company, as shown in the accompanying consolidated statements of cash flows for the three months ended March 31, 2009. Cash flow provided from operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of \$5,710,000 during the first three months of 2009. Investing activities consisting mainly of purchases, sales and maturities of available for sale

securities, and changes in the level of the loan portfolio, provided cash flow of \$5,417,000. The cash inflow primarily consisted of \$39,364,000 in proceeds from maturities, calls, and pay downs of investment securities, and a \$2,631,000 decrease in the loan portfolio, partially offset by \$36,673,000 of investment securities purchases. Financing activities used total cash of \$13,395,000, resulting primarily from \$45,199,000 repayment of FHLB advances offset by \$35,724,000 increase in deposits. Future short-term liquidity needs arising from daily operations are not expected to vary significantly during 2009.

Regulatory Capital

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

Quantitative measures established by regulations to ensure capital adequacy require our Company and our Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital to risk-weighted assets, and of Tier I capital to adjusted-average assets. Management believes, as of March 31, 2009 and December 31, 2008, our Company and our Bank each meet all capital adequacy requirements to which they are subject.

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

| | Actual | | Minimum Capital requirements | | Well-Capitalized Capital Requirements | |
|---|------------|--------|---------------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| March 31, 2009 | | | | | | |
| Total capital (to risk-weighted assets): | | | | | | |
| Company | \$ 164,084 | 16.22% | \$ 80,948 | 8.00% | | |
| Hawthorn Bank | 127,915 | 12.73 | 80,392 | 8.00 | \$ 100,490 | 10.00% |
| Tier I capital (to risk-weighted assets): | | | | | | |
| Company | \$ 138,576 | 13.70 | \$ 40,474 | 4.00% | | |
| Hawthorn Bank | 115,354 | 11.48 | 40,196 | 4.00 | \$ 60,294 | 6.00% |
| Tier I capital (to adjusted average assets): | | | | | | |
| Company | \$ 138,576 | 11.02 | \$ 37,730 | 3.00% | | |
| Hawthorn Bank | 115,354 | 9.23 | 37,478 | 3.00 | \$ 62,463 | 5.00% |

| | Actual | | Minimum Capital requirements | | Well-Capitalized Capital Requirements | |
|--|--------|-------|---------------------------------|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |

December 31, 2008

Total capital (to risk-weighted assets):

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| | | | | | | |
|---------------|------------|--------|-----------|-------|------------|--------|
| Company | \$ 163,949 | 16.01% | \$ 81,912 | 8.00% | | |
| Hawthorn Bank | 125,510 | 12.35 | 81,310 | 8.00 | \$ 101,638 | 10.00% |

Tier I capital (to risk-weighted assets):

| | | | | | | |
|---------------|------------|-------|-----------|-------|-----------|-------|
| Company | \$ 138,756 | 13.55 | \$ 40,956 | 4.00% | | |
| Hawthorn Bank | 113,158 | 11.13 | 40,655 | 4.00 | \$ 60,983 | 6.00% |

Tier I capital (to adjusted average assets):

| | | | | | | |
|---------------|------------|-------|-----------|-------|-----------|-------|
| Company | \$ 138,756 | 10.80 | \$ 38,543 | 3.00% | | |
| Hawthorn Bank | 113,158 | 8.82 | 38,497 | 3.00 | \$ 64,162 | 5.00% |

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk arises from exposure to changes in interest rates and other relevant market rate or price risk. Our Company faces market risk in the form of interest rate risk through transactions other than trading activities. Our Company uses financial modeling techniques to measure interest rate risk. These techniques measure the sensitivity of future earnings due to changing interest rate environments. Guidelines established by our Company's Asset/Liability Committee and approved by the Board of Directors are used to monitor exposure of earnings at risk. General interest rate movements are used to develop sensitivity as our Company feels it has no primary exposure to specific points on the yield curve. For the period ended March 31, 2009, our Company utilized a 300 basis point immediate and gradual move in interest rates (both upward and downward) applied to both a parallel and proportional yield curve.

The following table represents estimated interest rate sensitivity and periodic and cumulative gap positions calculated as of March 31, 2009:

| <i>(Dollars in thousands)</i> | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Over 5 years or no stated Maturity | Total |
|--|--------------------|-------------------|-------------------|--------------------|-------------------|---|---------------------|
| ASSETS | | | | | | | |
| Investment securities | \$ 37,204 | \$ 12,321 | \$ 7,461 | \$ 9,824 | \$ 14,203 | \$ 74,324 | \$ 155,337 |
| Interest-bearing deposits | 33,093 | | | | | | 33,093 |
| Federal funds sold and securities purchased under agreements to resell | 116 | | | | | | 116 |
| Loans | 496,887 | 167,620 | 139,732 | 74,293 | 86,719 | 26,120 | 991,371 |
| Total | \$ 567,300 | \$ 179,941 | \$ 147,193 | \$ 84,117 | \$ 100,922 | \$ 100,444 | \$ 1,179,917 |
| LIABILITIES | | | | | | | |
| Savings, Now deposits | \$ | \$ | \$ | \$ 127,008 | \$ | \$ | \$ 127,008 |
| Rewards checking, Super Now, money market deposits | 233,956 | | | | | | 233,956 |
| Time deposits | 382,250 | 64,028 | 31,096 | 4,733 | 24,161 | 110 | 506,378 |
| Federal funds purchased and securities sold under agreements to repurchase | 26,322 | | | | | | 26,322 |
| Subordinated notes | 49,486 | | | | | | 49,486 |
| Other borrowed money | 22,766 | 37,338 | 23,485 | 247 | 22 | | 83,858 |
| Total | \$ 714,780 | \$ 101,366 | \$ 54,581 | \$ 131,988 | \$ 24,183 | \$ 110 | \$ 1,027,008 |
| | \$(147,480) | \$ 78,575 | \$ 92,612 | \$ (47,871) | \$ 76,739 | \$ 100,334 | \$ 152,909 |

Interest-sensitivity
GAP Periodic GAP

| | | | | | | | |
|----------------|-------------|------------|-----------|------------|-----------|-----------|------------|
| Cumulative GAP | \$(147,480) | \$(68,905) | \$ 23,707 | \$(24,164) | \$ 52,575 | \$152,909 | \$ 152,909 |
|----------------|-------------|------------|-----------|------------|-----------|-----------|------------|

Ratio of
interest-earnings assets
to interest-bearing
liabilities

| | | | | | | | |
|----------------|------|------|------|------|------|--------|------|
| Periodic GAP | 0.79 | 1.78 | 2.70 | 0.64 | 4.17 | 913.13 | 1.15 |
| Cumulative GAP | 0.79 | 0.92 | 1.03 | 0.98 | 1.05 | 1.15 | 1.15 |

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 March 31, 2009. Based upon and as of the date of that evaluation, our principal executive and principal financial officers concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported as and when required. It

should be noted that any system of disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any system of disclosure controls and procedures is based in part upon assumptions about the likelihood of future events. Because of these and other inherent limitations of any such system, there can be no assurance that any design will always succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

There has been no change in our Company's internal control over financial reporting that occurred during the fiscal quarter ended March 31, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Impact of New Accounting Pronouncements

In December 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP), *Employers' Disclosures about Postretirement Benefit Plan Assets*, FSP FAS 132R-1, an amendment of Statement of Financial Accounting Standard (SFAS) No. 132R, *Employers' Disclosures about Pensions and Other Postretirement Benefits*. This position will require more detailed disclosures regarding defined benefit pension plan assets including investment policies and strategies, major categories of plan assets, valuation techniques used to measure the fair value of plan assets and significant concentrations of risk within plan assets. This position becomes effective for fiscal years ending after December 15, 2009. Upon initial application, the provisions of this position are not required for earlier periods that are presented for comparative purposes. Our Company is currently evaluating the disclosure requirements of this new position.

Effective January 1, 2009, our Company adopted FASB Staff Position No. 157-2, which delayed the effective date of SFAS No. 157 *Fair Value Measurement*, for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), to fiscal years and interim periods beginning after November 15, 2008. SFAS No. 157-2 requires separate disclosure of assets and liabilities measured at fair value on a recurring basis, as documented above, from those measured at fair value on a nonrecurring basis. Nonfinancial assets measured at fair value on a nonrecurring basis would include foreclosed real estate, long-lived assets, goodwill, and core deposit intangible assets, which are reviewed annually in the fourth quarter and/or when circumstances or other events indicate that impairment may have occurred. No circumstances or events happened that indicated impairment may have occurred in the three months ended March 31, 2009; therefore, no measurement at fair value was required for these nonfinancial assets.

In April 2009 the FASB issued Staff Position SFAS No. 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (SFAS No. 157-4). This position provides guidelines for making fair value measurements more consistent with the principles presented in SFAS No. 157. SFAS No. 157-4 related to determining fair values when there is no active market or where the price inputs being used represent distressed sales. SFAS No. 157-4, which reaffirms SFAS No. 157, states that the objective of fair value measurement is to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. This position will become effective for interim and fiscal years ending after June 15, 2009, with early adoption permitted. Our Company does not expect the adoption of SFAS No. 157-4 in the period ending June 30, 2009 to have a material effect on our consolidated financial position or results of operations.

In April 2009 the FASB issued SFAS 115-2 and 124-2, *Recognition and Presentation of Other-than-Temporary Impairment* (SFAS 115-2 and 124-2). This position modifies the requirements for recognizing other than temporary impairment on debt securities and significantly changes the impairment model for such securities. Under SFAS 115-2 and 124-2, a security is considered to be other than temporarily impaired if the present value of cash flows expected to be collected are less than the security's amortized cost basis or if the fair value of the security is less than the security's amortized cost basis and the investor intends, or more likely than not will be required, to sell the security before recovery of the security's amortized cost basis. If an other than temporary impairment exists, the charge to earnings is limited to the amount of credit loss. If the investor does not intend to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of the security's amortized cost basis, any remaining difference between fair value and amortized cost is recognized in other comprehensive income, net of applicable taxes. Otherwise, the entire difference between fair value and amortized cost is charged to earnings. Upon adoption of

this position, an entity reclassifies from retained earnings to other comprehensive

income the non-credit portion of an other than temporary impairment loss previously recognized on a security it holds if the entity does not intend to sell the security, and it is more likely than not that it will not be required to sell the security, before recovery of the security's amortized cost basis. This position also modifies the presentation of other than temporary impairment losses and increases related to disclosure requirements. SFAS 115-2 and 124-2 are effective for periods ending June 15, 2009, with earlier adoption permitted. Our Company is currently assessing the impact of adoption of SFAS 115-2 and 124-2 on our consolidated financial position and results of operations as of, and for, the period ending June 30, 2009.

In April 2009 the FASB issued SFAS No. 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Statements* (SFAS No. 107-1 and APB 28-1). SFAS No. 107-1 and APB 28-1 require companies to disclose the fair value of financial instruments within interim financial statements, adding to the current requirement to provide those disclosures annually. Since SFAS 107-1 and 124-2 address financial statement disclosures only, our Company's adoption, effective June 30, 2009, will not impact our consolidated financial position or results of operations.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* (Statement 141R) and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment to ARB No. 51* (Statement 160). Statements 141R and 160 require most identifiable assets, liabilities, noncontrolling interests, and goodwill acquired in a business combination to be recorded at full fair value and require noncontrolling interests (previously referred to as minority interests) to be reported as a component of equity, which changes the accounting for transactions with noncontrolling interest holders. Both statements are effective for periods beginning on or after December 15, 2008, and earlier adoption is prohibited. Statement 141R will be applied to business combinations occurring after the effective date. Statement 160 will be applied prospectively to all noncontrolling interests, including any that arose before the effective date. The provisions of Statement 141R and SFAS 160 were adopted on January 1, 2009 and did not have a material impact on our Company's results of operations and financial position.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 gives our Company the irrevocable option to carry most financial assets and liabilities at fair value that are not currently required to be measured at fair value. If the fair value option is elected, changes in fair value would be recorded in earnings at each subsequent reporting date. SFAS 159 is effective for our Company's 2008 fiscal year. Our Company has not elected the fair value option for any financial assets or liabilities at March 31, 2009.

PART II OTHER INFORMATION

| | | |
|-------------|---|------|
| Item 1. | Legal Proceedings | None |
| Item 1A. | Risk Factors | None |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | None |
| Item 3. | Defaults Upon Senior Securities | None |
| Item 4. | Submission of Matters to a Vote of Security Holders | None |
| Item 5. | Other Information | None |
| Item 6. | Exhibits | |
| Exhibit No. | Description | |
| 3.1 | Restated Articles of Incorporation of our Company (filed as Exhibit 3.1 to our Company's current report on Form 8-K on August 9, 2007 and incorporated herein by reference). | |
| 3.1.1 | Certificate of Designations of Fixed Rate Cumulative Perpetual Preferred Stock, Series 2008, dated December 17, 2008 (filed as Exhibit 3.1.1 to our Company's current report on Form 8-K on December 23, 2008 and incorporated herein by reference). | |
| 3.2 | Amended and Restated Bylaws of our Company (filed as Exhibit 3.2 to our Company's current report on Form 8-K on November 1, 2007 and incorporated herein by reference). | |
| 4.1 | Specimen certificate representing shares of our Company's \$1.00 par value common stock (filed as Exhibit 4.1 to our Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1999 (Commission file number 0-23636) and incorporated herein by reference). | |
| 4.2 | Specimen certificate representing shares of our Fixed Rate Cumulative Perpetual Preferred Stock, Series 2008 (filed as Exhibit 4.2 to our Company's current report on Form 8-K on December 23, 2008 and incorporated herein by reference). | |
| 4.3 | Warrant to purchase shares of our Company's \$1.00 par value Common Stock, dated December 19, 2008 (filed as Exhibit 4.3 to our Company's current report on Form 8-K on December 23, 2008 and incorporated herein by reference). | |
| 31.1 | Certificate of the Chief Executive Officer of our Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | |
| 31.2 | Certificate of the Chief Financial Officer of our Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | |
| 32.1 | Certificate of the Chief Executive Officer of our Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | |

32.2

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

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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

May 8, 2009

/s/ James E. Smith

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

May 8, 2009

/s/ Richard G. Rose

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

HAWTHORN BANCSHARES, INC.

INDEX TO EXHIBITS

March 31, 2009 Form 10-Q

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** Incorporated by reference.

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