**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

*(Mark One)*

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

For the quarterly period ended September 30, 2019

OR

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

For the transition period from \_\_\_\_\_\_\_\_\_\_\_\_\_\_ to \_\_\_\_\_\_\_\_\_\_\_\_\_\_

Commission file number: 0‑23636

**HAWTHORN BANCSHARES, INC.**

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

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

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

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

**(573) 761‑6100**

*(Registrant’s telephone number, including area code)*

**N/A**

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

Securities registered pursuant to Section 12(b) of the Act:

|  |  |  |
| --- | --- | --- |
|  |  |  |
| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
| Common Stock, $1.00 par value | HWBK | The Nasdaq Stock Market LLC |

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 every Interactive Data File required to be submitted 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 such files). ☒ Yes ◻ No

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

|  |  |  |
| --- | --- | --- |
|  |  |  |
| Large accelerated filer ◻ | Accelerated filer ☒ | Non-accelerated filer ◻ |
|  |  |  |
| Smaller reporting company ☒ | Emerging growth company ◻ |  |

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

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

As of November 7, 2019, the registrant had 6,276,236 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**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
| (In thousands, except per share data) |  | **September 30,** | |  | **December 31,** | |
|  |  | **2019** | |  | **2018** | |
|  |  | *(Unaudited)* | |  |  | |
| **ASSETS** |  |  |  |  |  |  |
| Cash and due from banks |  | $ | 22,856 |  | $ | 23,687 |
| Federal funds sold and other interest-bearing deposits |  |  | 21,559 |  |  | 18,396 |
| Cash and cash equivalents |  |  | 44,415 |  |  | 42,083 |
| Certificates of deposit in other banks |  |  | 11,601 |  |  | 12,247 |
| Available-for-sale debt securities, at fair value |  |  | 181,270 |  |  | 218,205 |
| Other investments |  |  | 6,210 |  |  | 5,675 |
| **Total investment securities** |  |  | 187,480 |  |  | 223,880 |
| Loans |  |  | 1,151,518 |  |  | 1,146,627 |
| Allowances for loan losses |  |  | (12,178) |  |  | (11,652) |
| **Net loans** |  |  | 1,139,340 |  |  | 1,134,975 |
| Premises and equipment - net |  |  | 35,754 |  |  | 34,894 |
| Mortgage servicing rights |  |  | 2,575 |  |  | 2,931 |
| Other real estate owned - net |  |  | 12,878 |  |  | 13,691 |
| Accrued interest receivable |  |  | 6,215 |  |  | 6,162 |
| Cash surrender value - life insurance |  |  | 2,385 |  |  | 2,542 |
| Other assets |  |  | 6,695 |  |  | 8,277 |
| **Total assets** |  | $ | 1,449,338 |  | $ | 1,481,682 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** |  |  |  |  |  |  |
| Deposits |  |  |  |  |  |  |
| Non-interest bearing demand |  | $ | 284,452 |  | $ | 262,857 |
| Savings, interest checking and money market |  |  | 550,350 |  |  | 614,040 |
| Time deposits $250,000 and over |  |  | 94,970 |  |  | 104,900 |
| Other time deposits |  |  | 207,635 |  |  | 216,671 |
| **Total deposits** |  |  | 1,137,407 |  |  | 1,198,468 |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 27,191 |  |  | 24,647 |
| Federal Home Loan Bank advances and other borrowings |  |  | 106,980 |  |  | 95,153 |
| Subordinated notes |  |  | 49,486 |  |  | 49,486 |
| Operating lease liabilities |  |  | 2,285 |  |  | — |
| Accrued interest payable |  |  | 1,020 |  |  | 1,035 |
| Other liabilities |  |  | 12,155 |  |  | 13,479 |
| **Total liabilities** |  |  | 1,336,524 |  |  | 1,382,268 |
| Stockholders’ equity: |  |  |  |  |  |  |
| Common stock, $1 par value, authorized 15,000,000 shares; issued 6,519,874 and 6,278,481 shares, respectively |  |  | 6,520 |  |  | 6,279 |
| Surplus |  |  | 55,727 |  |  | 50,173 |
| Retained earnings |  |  | 58,275 |  |  | 54,105 |
| Accumulated other comprehensive loss, net of tax |  |  | (2,664) |  |  | (6,099) |
| Treasury stock; 243,638 shares, at cost |  |  | (5,044) |  |  | (5,044) |
| **Total stockholders’ equity** |  |  | 112,814 |  |  | 99,414 |
| **Total liabilities and stockholders’ equity** |  | $ | 1,449,338 |  | $ | 1,481,682 |

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

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**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended** | | | | |  | **Nine Months Ended** | | | | |  |
|  |  | **September 30,** | | | | |  | **September 30,** | | | | |  |
| ***(In thousands, except per share amounts)*** |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| **INTEREST INCOME** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Interest and fees on loans |  | $ | 14,806 |  | $ | 13,252 |  | $ | 43,662 |  | $ | 38,329 |  |
| Interest on investment securities: |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Taxable |  |  | 831 |  |  | 1,089 |  |  | 2,857 |  |  | 3,141 |  |
| Nontaxable |  |  | 119 |  |  | 146 |  |  | 408 |  |  | 451 |  |
| Federal funds sold, other interest-bearing deposits, and certificates of deposit in other banks |  |  | 103 |  |  | 205 |  |  | 897 |  |  | 500 |  |
| Dividends on other investments |  |  | 66 |  |  | 59 |  |  | 199 |  |  | 162 |  |
| **Total interest income** |  |  | 15,925 |  |  | 14,751 |  |  | 48,023 |  |  | 42,583 |  |
| **INTEREST EXPENSE** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Interest on deposits: |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Savings, interest checking and money market |  |  | 1,047 |  |  | 1,468 |  |  | 4,217 |  |  | 3,899 |  |
| Time deposit accounts $250,000 and over |  |  | 475 |  |  | 391 |  |  | 1,761 |  |  | 825 |  |
| Time deposits |  |  | 801 |  |  | 520 |  |  | 2,268 |  |  | 1,566 |  |
| **Total interest expense on deposits** |  |  | 2,323 |  |  | 2,379 |  |  | 8,246 |  |  | 6,290 |  |
| Interest on federal funds purchased and securities sold under agreements to repurchase |  |  | 34 |  |  | 166 |  |  | 110 |  |  | 526 |  |
| Interest on Federal Home Loan Bank advances |  |  | 619 |  |  | 314 |  |  | 1,699 |  |  | 1,042 |  |
| Interest on subordinated notes |  |  | 588 |  |  | 584 |  |  | 1,821 |  |  | 1,635 |  |
| **Total interest expense on borrowings** |  |  | 1,241 |  |  | 1,064 |  |  | 3,630 |  |  | 3,203 |  |
| **Total interest expense** |  |  | 3,564 |  |  | 3,443 |  |  | 11,876 |  |  | 9,493 |  |
| **Net interest income** |  |  | 12,361 |  |  | 11,308 |  |  | 36,147 |  |  | 33,090 |  |
| Provision for loan losses |  |  | 450 |  |  | 250 |  |  | 850 |  |  | 1,000 |  |
| **Net interest income after provision for loan losses** |  |  | 11,911 |  |  | 11,058 |  |  | 35,297 |  |  | 32,090 |  |
| **NON-INTEREST INCOME** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Service charges and other fees |  |  | 953 |  |  | 942 |  |  | 2,701 |  |  | 2,760 |  |
| Bank card income and fees |  |  | 794 |  |  | 699 |  |  | 2,282 |  |  | 2,064 |  |
| Trust department income |  |  | 371 |  |  | 276 |  |  | 960 |  |  | 867 |  |
| Real estate servicing fees, net |  |  | 36 |  |  | 192 |  |  | 38 |  |  | 574 |  |
| Gain on sale of mortgage loans, net |  |  | 215 |  |  | 205 |  |  | 499 |  |  | 592 |  |
| Other |  |  | 55 |  |  | 50 |  |  | 157 |  |  | 113 |  |
| **Total non-interest income** |  |  | 2,424 |  |  | 2,364 |  |  | 6,637 |  |  | 6,970 |  |
| **Investment securities (loss) gain, net** |  |  | (40) |  |  | 50 |  |  | (40) |  |  | 256 |  |
| **Gain on branch sale, net** |  |  | 109 |  |  | — |  |  | 2,183 |  |  | — |  |
| **NON-INTEREST EXPENSE** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Salaries and employee benefits |  |  | 5,366 |  |  | 5,543 |  |  | 16,220 |  |  | 17,413 |  |
| Occupancy expense, net |  |  | 909 |  |  | 749 |  |  | 2,348 |  |  | 2,162 |  |
| Furniture and equipment expense |  |  | 671 |  |  | 785 |  |  | 2,166 |  |  | 2,104 |  |
| Processing, network, and bank card expense |  |  | 893 |  |  | 841 |  |  | 2,867 |  |  | 2,589 |  |
| Legal, examination, and professional fees |  |  | 316 |  |  | 289 |  |  | 948 |  |  | 913 |  |
| Advertising and promotion |  |  | 343 |  |  | 297 |  |  | 884 |  |  | 840 |  |
| Postage, printing, and supplies |  |  | 181 |  |  | 256 |  |  | 650 |  |  | 749 |  |
| Other |  |  | 911 |  |  | 1,168 |  |  | 3,066 |  |  | 3,368 |  |
| **Total non-interest expense** |  |  | 9,590 |  |  | 9,928 |  |  | 29,149 |  |  | 30,138 |  |
| Income before income taxes |  |  | 4,814 |  |  | 3,544 |  |  | 14,928 |  |  | 9,178 |  |
| Income tax expense |  |  | 954 |  |  | 446 |  |  | 2,882 |  |  | 1,083 |  |
| **Net income** |  |  | 3,860 |  |  | 3,098 |  | $ | 12,046 |  | $ | 8,095 |  |
| Basic earnings per share |  | $ | 0.62 |  | $ | 0.49 |  | $ | 1.92 |  | $ | 1.29 |  |
| Diluted earnings per share |  | $ | 0.62 |  | $ | 0.49 |  | $ | 1.92 |  | $ | 1.29 |  |

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

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**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended** | | | | |  | **Nine Months Ended** | | | | |  |
|  |  | **September 30,** | | | | |  | **September 30,** | | | | |  |
| ***(In thousands)*** |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| Net income |  | $ | 3,860 |  | $ | 3,098 |  | $ | 12,046 |  | $ | 8,095 |  |
| Other comprehensive income (loss), net of tax |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Investment securities available-for-sale: |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Unrealized gain (loss) on investment securities available-for-sale, net of tax |  |  | 280 |  |  | (936) |  |  | 3,357 |  |  | (3,093) |  |
| Adjustment for gain on sale of investment securities, net of tax |  |  | 32 |  |  | — |  |  | 32 |  |  | — |  |
| Defined benefit pension plans: |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Amortization of prior service cost included in net periodic pension cost, net of tax |  |  | 15 |  |  | 44 |  |  | 46 |  |  | 129 |  |
| Total other comprehensive income (loss) |  |  | 327 |  |  | (892) |  |  | 3,435 |  |  | (2,964) |  |
| Total comprehensive income |  | $ | 4,187 |  | $ | 2,206 |  | $ | 15,481 |  | $ | 5,131 |  |

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

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**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Stockholders’ Equity** *(unaudited)*

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  | **Accumulated** | |  |  |  |  | **Total** | |
|  |  |  |  |  |  |  |  |  |  |  | **Other** | |  |  |  |  | **Stock -** | |
|  |  | **Common** | |  |  |  |  | **Retained** | |  | **Comprehensive** | |  | **Treasury** | |  | **holders'** | |
| ***(In thousands)*** |  | **Stock** | |  | **Surplus** | |  | **Earnings** | |  | **Loss** | |  | **Stock** | |  | **Equity** | |
| **Balance, June 30, 2018** |  | $ | 6,047 |  | $ | 50,456 |  | $ | 49,594 |  | $ | (7,734) |  | $ | (5,230) |  | $ | 93,133 |
| Net income |  |  | — |  |  | — |  |  | 3,098 |  |  | — |  |  | — |  |  | 3,098 |
| Other comprehensive loss |  |  | — |  |  | — |  |  | — |  |  | (892) |  |  | — |  |  | (892) |
| Issuance of stock under equity compensation plan |  |  | — |  |  | (51) |  |  | — |  |  | — |  |  | 186 |  |  | 135 |
| Stock dividend |  |  | 232 |  |  | (232) |  |  | — |  |  | — |  |  | — |  |  | — |
| Cash dividends declared, common stock |  |  | — |  |  | — |  |  | (602) |  |  | — |  |  | — |  |  | (602) |
| **Balance, September 30, 2018** |  | $ | 6,279 |  | $ | 50,173 |  | $ | 52,090 |  | $ | (8,626) |  | $ | (5,044) |  | $ | 94,872 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Balance, December 31, 2017** |  | $ | 6,047 |  | $ | 45,442 |  | $ | 50,595 |  | $ | (5,662) |  | $ | (5,051) |  | $ | 91,371 |
| Net income |  |  | — |  |  | — |  |  | 8,095 |  |  | — |  |  | — |  |  | 8,095 |
| Other comprehensive loss |  |  | — |  |  | — |  |  | — |  |  | (2,964) |  |  | — |  |  | (2,964) |
| Issuance of stock under equity compensation plan |  |  | — |  |  | (51) |  |  | — |  |  | — |  |  | 186 |  |  | 135 |
| Purchase of treasury stock |  |  | — |  |  | — |  |  | — |  |  | — |  |  | (179) |  |  | (179) |
| Stock dividend |  |  | 232 |  |  | 4,782 |  |  | (5,014) |  |  | — |  |  | — |  |  | — |
| Cash dividends declared, common stock |  |  | — |  |  | — |  |  | (1,586) |  |  | — |  |  | — |  |  | (1,586) |
| **Balance, September 30, 2018** |  | $ | 6,279 |  | $ | 50,173 |  | $ | 52,090 |  | $ | (8,626) |  | $ | (5,044) |  | $ | 94,872 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  | **Accumulated** | |  |  |  |  | **Total** | |
|  |  |  |  |  |  |  |  |  |  |  | **Other** | |  |  |  |  | **Stock -** | |
|  |  | **Common** | |  |  |  |  | **Retained** | |  | **Comprehensive** | |  | **Treasury** | |  | **holders'** | |
| ***(In thousands)*** |  | **Stock** | |  | **Surplus** | |  | **Earnings** | |  | **Loss** | |  | **Stock** | |  | **Equity** | |
| **Balance, June 30, 2019** |  | $ | 6,279 |  | $ | 55,968 |  | $ | 55,168 |  | $ | (2,991) |  | $ | (5,044) |  | $ | 109,380 |
| Net income |  |  | — |  |  | — |  |  | 3,860 |  |  | — |  |  | — |  |  | 3,860 |
| Other comprehensive income |  |  | — |  |  | — |  |  | — |  |  | 327 |  |  | — |  |  | 327 |
| Stock dividend |  |  | 241 |  |  | (241) |  |  | — |  |  | — |  |  | — |  |  | — |
| Cash dividends declared, common stock |  |  | — |  |  | — |  |  | (753) |  |  | — |  |  | — |  |  | (753) |
| **Balance, September 30, 2019** |  | $ | 6,520 |  | $ | 55,727 |  | $ | 58,275 |  | $ | (2,664) |  | $ | (5,044) |  | $ | 112,814 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Balance, December 31, 2018** |  | $ | 6,279 |  | $ | 50,173 |  | $ | 54,105 |  | $ | (6,099) |  | $ | (5,044) |  | $ | 99,414 |
| Net income |  |  | — |  |  | — |  |  | 12,046 |  |  | — |  |  | — |  |  | 12,046 |
| Other comprehensive income |  |  | — |  |  | — |  |  | — |  |  | 3,435 |  |  | — |  |  | 3,435 |
| Stock dividend |  |  | 241 |  |  | 5,554 |  |  | (5,795) |  |  | — |  |  | — |  |  | — |
| Cash dividends declared, common stock |  |  | — |  |  | — |  |  | (2,081) |  |  | — |  |  | — |  |  | (2,081) |
| **Balance, September 30, 2019** |  | $ | 6,520 |  | $ | 55,727 |  | $ | 58,275 |  | $ | (2,664) |  | $ | (5,044) |  | $ | 112,814 |

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

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**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **Nine Months Ended September 30,** | | | | |
| ***(In thousands)*** |  | **2019** | |  | **2018** | |
| **Cash flows from operating activities:** |  |  |  |  |  |  |
| Net income |  | $ | 12,046 |  | $ | 8,095 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |  |  |  |  |
| Provision for loan losses |  |  | 850 |  |  | 1,000 |
| Depreciation expense |  |  | 1,505 |  |  | 1,321 |
| Net amortization of investment securities, premiums, and discounts |  |  | 1,023 |  |  | 1,121 |
| Change in fair value of mortgage servicing rights |  |  | 543 |  |  | 40 |
| Investment securities (loss) gain, net |  |  | 40 |  |  | (256) |
| Loss on sales and dispositions of premises and equipment |  |  | 53 |  |  | 3 |
| Gain on sales and dispositions of other real estate |  |  | (102) |  |  | — |
| Gain on branch sale, net |  |  | (2,183) |  |  | — |
| Provision for other real estate owned |  |  | 49 |  |  | 26 |
| Operating lease expense |  |  | (140) |  |  | — |
| Increase in accrued interest receivable |  |  | (53) |  |  | (357) |
| Increase in cash surrender value - life insurance |  |  | (65) |  |  | (51) |
| Decrease in other assets |  |  | 878 |  |  | 849 |
| (Decrease) increase in accrued interest payable |  |  | (15) |  |  | 436 |
| Decrease in other liabilities |  |  | (1,466) |  |  | (1,038) |
| Origination of mortgage loans for sale |  |  | (29,443) |  |  | (29,197) |
| Proceeds from the sale of mortgage loans |  |  | 28,275 |  |  | 30,049 |
| Gain on sale of mortgage loans, net |  |  | (499) |  |  | (592) |
| Other, net |  |  | (187) |  |  | (199) |
| **Net cash provided by operating activities** |  |  | 11,109 |  |  | 11,250 |
| **Cash flows from investing activities:** |  |  |  |  |  |  |
| Purchase of certificates of deposit in other banks |  |  | (988) |  |  | (8,783) |
| Proceeds from maturities of certificates of deposit in other banks |  |  | 1,634 |  |  | — |
| Net increase in loans |  |  | (3,959) |  |  | (48,675) |
| Purchase of available-for-sale debt securities |  |  | (20,423) |  |  | (102,953) |
| Proceeds from maturities of available-for-sale debt securities |  |  | 29,460 |  |  | 25,782 |
| Proceeds from calls of available-for-sale debt securities |  |  | 9,620 |  |  | 1,685 |
| Proceeds from sales of available-for-sale debt securities |  |  | 21,503 |  |  | 77,168 |
| Purchases of FHLB stock |  |  | (6,522) |  |  | (2,367) |
| Proceeds from sales of FHLB stock |  |  | 5,988 |  |  | 3,903 |
| Purchases of premises and equipment |  |  | (1,903) |  |  | (1,374) |
| Proceeds from sales of premises and equipment |  |  | 6 |  |  | 13 |
| Proceeds from Bank owned life insurance policy |  |  | 222 |  |  | — |
| Payment for branch sale, net |  |  | (6,700) |  |  | — |
| Proceeds from sales of other real estate and repossessed assets |  |  | 1,277 |  |  | 372 |
| **Net cash provided by (used in) investing activities** |  |  | 29,215 |  |  | (55,229) |
| **Cash flows from financing activities:** |  |  |  |  |  |  |
| Net increase in demand deposits |  |  | 27,285 |  |  | 11,996 |
| Net (decrease) increase in interest-bearing transaction accounts |  |  | (60,433) |  |  | 24,748 |
| Net (decrease) increase in time deposits |  |  | (17,284) |  |  | 20,178 |
| Net increase in federal funds purchased and securities sold under agreements to repurchase |  |  | 2,544 |  |  | 5,100 |
| Repayment of FHLB advances and other borrowings |  |  | (166,647) |  |  | (173,619) |
| FHLB advances |  |  | 178,474 |  |  | 130,950 |
| Issuance of stock under equity compensation plan |  |  | — |  |  | 135 |
| Purchase of treasury stock |  |  | — |  |  | (179) |
| Cash dividends paid - common stock |  |  | (1,931) |  |  | (1,390) |
| **Net cash (used in) provided by financing activities** |  |  | (37,992) |  |  | 17,919 |
| Net increase (decrease) in cash and cash equivalents |  |  | 2,332 |  |  | (26,060) |
| Cash and cash equivalents, beginning of year |  |  | 42,083 |  |  | 62,878 |
| **Cash and cash equivalents, end of year** |  | $ | 44,415 |  | $ | 36,818 |
| **Supplemental disclosures of cash flow information:** |  |  |  |  |  |  |
| Cash paid during the year for: |  |  |  |  |  |  |
| Interest |  | $ | 11,891 |  | $ | 9,058 |
| Income taxes |  | $ | 2,280 |  | $ | 50 |
| **Noncash investing and financing activities:** |  |  |  |  |  |  |
| Other real estate and repossessed assets acquired in settlement of loans |  | $ | 411 |  | $ | 589 |
| Net deposits and fixed assets transferred to other assets related to the Branson branch sale |  | $ | (8,885) |  | $ | — |
| Right of use assets obtained in exchange for new operating lease liabilities |  | $ | 2,424 |  | $ | — |
| Stock dividends |  | $ | 5,795 |  | $ | 5,014 |

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

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**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

**(1)   Summary of Significant Accounting Policies**

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

The accompanying unaudited consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instructions to Form 10‑Q, and Rule 10‑01 of Regulation S-X. Accordingly, the unaudited consolidated financial statements do not include all of the information and disclosures required by U.S. GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes included in the Company’s Annual Report on Form 10‑K for the year ended December 31, 2018.

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

***Stock Dividend*** On July 1, 2019, the Company paid a special stock dividend of four percent to shareholders of record at the close of business on June 15, 2019. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

***Summary of Recent Transactions and Events*** On February 8, 2019, Hawthorn Bank, a wholly-owned subsidiary of the Company, completed the sale of its branch located in Branson, Missouri with total deposits of approximately $10.6 million to Branson Bank in Branson, Missouri. The transaction excludes loans assigned to the branch. The sale resulted in a pre-tax gain of approximately $2.2 million, or $1.7 million after tax.

**The following represents significant new accounting principles adopted in 2019:**

***Leases*** On January 1, 2019, the Company adopted ASU No. 2016-02,  *Leases (Topic 842)* which requires that lessees and lessors recognize lease assets and lease liabilities on the balance sheet and disclose key information about leasing arrangements. The ASU primarily affects lessee accounting, which requires the lessee to recognize a right-of-use asset (ROU) and a liability to make lease payments for those leases classified as operating leases. For leases with a term of 12 months or less, an election by class of underlying asset not to recognize lease assets and lease liabilities is permitted. The ASU also provides additional guidance as to the definition of a lease, identification of lease components, and sale and leaseback transactions. The Company's operating leases primarily relate to office space and bank branches.

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**HAWTHORN BANCSHARES, INC.**

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*(Unaudited)*

In January 2018, the FASB issued ASU 2018-01, which allows entities the option to apply the provisions of the new lease guidance at the effective date without adjusting the comparative periods presented. In July 2018, the FASB issued ASU 2018-10, which provides narrow-scope improvements to the lease standard and ASU 2018-11, which allows entities to choose an additional transition method, under which an entity initially applies the new lease standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Under this transitional method, the entity shall recognize and measure the leases that exist at the adoption date and the prior comparative periods are not adjusted. The Company adopted this ASU as of January 1, 2019 using the transitional method. In addition, the Company utilized the practical expedients that allowed it to retain the classifications of existing leases, not re-assess if existing leases have initial direct costs, and hindsight when determining the lease term and assessment of impairment. The adoption of ASU 2016-02 and related transition guidance resulted in the recording of right-of-use assets and lease liabilities on the consolidated balance sheets of $2.3 million and $2.3 million, respectively; however, it did not have a material impact on the Company's other consolidated financial statements.  See Note 7 - *Leases* for additional information.

***Derivatives and Hedging*** The FASB issued guidance within ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities (Topic 815)* in August 2017. The amendments in ASU 2017-12 to Topic 815, Derivatives and Hedging, are intended to more closely align hedge accounting with companies' risk management strategies, simplify the application of hedge accounting, and increase transparency as to the scope and results of hedging programs. The guidance also amends the presentation and disclosure requirements and changes how companies assess effectiveness. Under the new guidance, public companies will have until the end of the first quarter in which a hedge is designated to perform an initial assessment of a hedge's effectiveness. After initial qualification, the new guidance permits a qualitative effectiveness assessment for certain hedges instead of a quantitative test if the company can reasonably support an expectation of high effectiveness throughout the term of the hedge. Additional disclosures include cumulative basis adjustments for fair value hedges and the effect of hedging on individual income statement line items. The amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. The ASU did not have a significant effect on the Company's Consolidated Financial Statements.

**(2)   Loans and Allowance for Loan Losses**

*Loans*

A summary of loans, by major class within the Company’s loan portfolio, at September 30, 2019 and December 31, 2018 is as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |
| *(in thousands)* |  | **2019** | |  | **2018** | |
| Commercial, financial, and agricultural |  | $ | 193,267 |  | $ | 207,720 |
| Real estate construction - residential |  |  | 23,782 |  |  | 28,610 |
| Real estate construction - commercial |  |  | 124,389 |  |  | 106,784 |
| Real estate mortgage - residential |  |  | 248,435 |  |  | 241,517 |
| Real estate mortgage - commercial |  |  | 530,010 |  |  | 529,536 |
| Installment and other consumer |  |  | 31,635 |  |  | 32,460 |
| **Total loans** |  | $ | 1,151,518 |  | $ | 1,146,627 |

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the Missouri communities surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, and the greater Kansas City metropolitan area. As such, the Bank is susceptible to changes in the economic environment in these communities. The

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**HAWTHORN BANCSHARES, INC.**

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Notes to the Consolidated Financial Statements

*(Unaudited)*

Bank does not have a concentration of credit in any one economic sector. Installment and other consumer loans consist primarily of the financing of automotive vehicles. At September 30, 2019, loans of $501.0 million were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit.

*Allowance for Loan Losses*

The following table illustrates the changes in the allowance for loan losses by portfolio segment:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30, 2019** | | | | | | | | | | | | | | | | | | | | | | |
|  |  | **Commercial,** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Installment** | |  |  |  |  |  |  |
|  |  | **Financial, &** | |  | **Construction -** | |  | **Construction -** | |  | **Mortgage -** | |  | **Mortgage -** | |  | **and Other** | |  | **Un-** | |  |  |  |
| *(in thousands)* |  | **Agricultural** | |  | **Residential** | |  | **Commercial** | |  | **Residential** | |  | **Commercial** | |  | **Consumer** | |  | **allocated** | |  | **Total** | |
| **Balance at beginning of period** |  | **$** | **2,783** |  | **$** | **69** |  | **$** | **704** |  | **$** | **1,772** |  | **$** | **6,109** |  | **$** | **307** |  | **$** | **139** |  | **$** | **11,883** |
| Additions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Provision for loan losses |  |  | 155 |  |  | 3 |  |  | 97 |  |  | 252 |  |  | (15) |  |  | 62 |  |  | (104) |  |  | 450 |
| Deductions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Loans charged off |  |  | 61 |  |  | — |  |  | — |  |  | 86 |  |  | 6 |  |  | 60 |  |  | — |  |  | 213 |
| Less recoveries on loans |  |  | (12) |  |  | (12) |  |  | — |  |  | (8) |  |  | (7) |  |  | (19) |  |  | — |  |  | (58) |
| **Net loan charge-offs (recoveries)** |  |  | 49 |  |  | (12) |  |  | — |  |  | 78 |  |  | (1) |  |  | 41 |  |  | — |  |  | 155 |
| **Balance at end of period** |  | **$** | **2,889** |  | **$** | **84** |  | **$** | **801** |  | **$** | **1,946** |  | **$** | **6,095** |  | **$** | **328** |  | **$** | **35** |  | **$** | **12,178** |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Nine Months Ended September 30, 2019** | | | | | | | | | | | | | | | | | | | | | | |
|  |  | **Commercial,** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Installment** | |  |  |  |  |  |  |
|  |  | **Financial, &** | |  | **Construction -** | |  | **Construction -** | |  | **Mortgage -** | |  | **Mortgage -** | |  | **and Other** | |  | **Un-** | |  |  |  |
| *(in thousands)* |  | **Agricultural** | |  | **Residential** | |  | **Commercial** | |  | **Residential** | |  | **Commercial** | |  | **Consumer** | |  | **allocated** | |  | **Total** | |
| **Balance at beginning of period** |  | **$** | **3,237** |  | **$** | **140** |  | **$** | **757** |  | **$** | **2,071** |  | **$** | **4,914** |  | **$** | **334** |  | **$** | **199** |  | **$** | **11,652** |
| Additions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Provision for loan losses |  |  | (232) |  |  | (81) |  |  | 44 |  |  | 30 |  |  | 1,193 |  |  | 60 |  |  | (164) |  |  | 850 |
| Deductions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Loans charged off |  |  | 255 |  |  | — |  |  | — |  |  | 266 |  |  | 21 |  |  | 151 |  |  | — |  |  | 693 |
| Less recoveries on loans |  |  | (139) |  |  | (25) |  |  | — |  |  | (111) |  |  | (9) |  |  | (85) |  |  | — |  |  | (369) |
| **Net loan charge-offs (recoveries)** |  |  | 116 |  |  | (25) |  |  | — |  |  | 155 |  |  | 12 |  |  | 66 |  |  | — |  |  | 324 |
| **Balance at end of period** |  | **$** | **2,889** |  | **$** | **84** |  | **$** | **801** |  | **$** | **1,946** |  | **$** | **6,095** |  | **$** | **328** |  | **$** | **35** |  | **$** | **12,178** |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30, 2018** | | | | | | | | | | | | | | | | | | | | | | |
|  |  | **Commercial,** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Installment** | |  |  |  |  |  |  |
|  |  | **Financial, &** | |  | **Construction -** | |  | **Construction -** | |  | **Mortgage -** | |  | **Mortgage -** | |  | **and Other** | |  | **Un-** | |  |  |  |
| *(in thousands)* |  | **Agricultural** | |  | **Residential** | |  | **Commercial** | |  | **Residential** | |  | **Commercial** | |  | **Consumer** | |  | **allocated** | |  | **Total** | |
| **Balance at beginning of period** |  | **$** | **3,943** |  | **$** | **201** |  | **$** | **905** |  | **$** | **2,109** |  | **$** | **3,630** |  | **$** | **413** |  | **$** | **11** |  | **$** | **11,212** |
| Additions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Provision for loan losses |  |  | (420) |  |  | 26 |  |  | (159) |  |  | 255 |  |  | 444 |  |  | 39 |  |  | 65 |  |  | 250 |
| Deductions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Loans charged off |  |  | 75 |  |  | — |  |  | — |  |  | 32 |  |  | 5 |  |  | 74 |  |  | — |  |  | 186 |
| Less recoveries on loans |  |  | (38) |  |  | (13) |  |  | — |  |  | (9) |  |  | (2) |  |  | (20) |  |  | — |  |  | (82) |
| **Net loan charge-offs (recoveries)** |  |  | 37 |  |  | (13) |  |  | — |  |  | 23 |  |  | 3 |  |  | 54 |  |  | — |  |  | 104 |
| **Balance at end of period** |  | **$** | **3,486** |  | **$** | **240** |  | **$** | **746** |  | **$** | **2,341** |  | **$** | **4,071** |  | **$** | **398** |  | **$** | **76** |  | **$** | **11,358** |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Nine Months Ended September 30, 2018** | | | | | | | | | | | | | | | | | | | | | | |
|  |  | **Commercial,** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Installment** | |  |  |  |  |  |  |
|  |  | **Financial, &** | |  | **Construction -** | |  | **Construction -** | |  | **Mortgage -** | |  | **Mortgage -** | |  | **and Other** | |  | **Un-** | |  |  |  |
| *(in thousands)* |  | **Agricultural** | |  | **Residential** | |  | **Commercial** | |  | **Residential** | |  | **Commercial** | |  | **Consumer** | |  | **allocated** | |  | **Total** | |
| **Balance at beginning of period** |  | **$** | **3,325** |  | **$** | **170** |  | **$** | **807** |  | **$** | **1,689** |  | **$** | **4,437** |  |  | **345** |  | **$** | **79** |  | **$** | **10,852** |
| Additions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Provision for loan losses |  |  | 478 |  |  | 80 |  |  | (31) |  |  | 672 |  |  | (366) |  |  | 170 |  |  | (3) |  |  | 1,000 |
| Deductions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Loans charged off |  |  | 378 |  |  | 48 |  |  | 30 |  |  | 64 |  |  | 34 |  |  | 181 |  |  | — |  |  | 735 |
| Less recoveries on loans |  |  | (61) |  |  | (38) |  |  | — |  |  | (44) |  |  | (34) |  |  | (64) |  |  | — |  |  | (241) |
| **Net loan charge-offs (recoveries)** |  |  | 317 |  |  | 10 |  |  | 30 |  |  | 20 |  |  | — |  |  | 117 |  |  | — |  |  | 494 |
| **Balance at end of period** |  | **$** | **3,486** |  | **$** | **240** |  | **$** | **746** |  | **$** | **2,341** |  | **$** | **4,071** |  | **$** | **398** |  | **$** | **76** |  | **$** | **11,358** |

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**HAWTHORN BANCSHARES, INC.**

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Notes to the Consolidated Financial Statements

*(Unaudited)*

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

Beginning with the first quarter 2019, management adjusted the look-back period to begin with loss history in the first quarter 2012 and continue to include this starting point going forward. Management determined that with the current economic recovery continuing to set records for its length, the look-back period needed to be expanded to account for this extended economic cycle. This ever increasing look-back period will then be adjusted once a loss producing downturn is recognized by allowing the look-back period to shift forward by eliminating the earliest loss period and replenishing it with losses from the most recent period. Prior to 2019, the Company utilized a five-year look-back period, which was considered a representative historical loss period. The look-back period is consistently evaluated for relevance given the current facts and circumstances.

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**HAWTHORN BANCSHARES, INC.**

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The following table illustrates the allowance for loan losses and recorded investment by portfolio segment:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Commercial,** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Installment** | |  |  |  |  |  |  |
|  |  | **Financial, and** | |  | **Construction -** | |  | **Construction -** | |  | **Mortgage -** | |  | **Mortgage -** | |  | **and Other** | |  | **Un-** | |  |  |  |
| *(in thousands)* |  | **Agricultural** | |  | **Residential** | |  | **Commercial** | |  | **Residential** | |  | **Commercial** | |  | **Consumer** | |  | **allocated** | |  | **Total** | |
| **September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Allowance for loan losses:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Individually evaluated for impairment |  | $ | 361 |  | $ | — |  | $ | — |  | $ | 296 |  | $ | 34 |  | $ | 17 |  | $ | — |  | $ | 708 |
| Collectively evaluated for impairment |  |  | 2,528 |  |  | 84 |  |  | 801 |  |  | 1,650 |  |  | 6,061 |  |  | 311 |  |  | 35 |  |  | 11,470 |
| **Total** |  | $ | 2,889 |  | $ | 84 |  | $ | 801 |  | $ | 1,946 |  | $ | 6,095 |  | $ | 328 |  | $ | 35 |  | $ | 12,178 |
| **Loans outstanding:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Individually evaluated for impairment |  | $ | 1,578 |  | $ | — |  | $ | 145 |  | $ | 3,902 |  | $ | 1,469 |  | $ | 161 |  | $ | — |  | $ | 7,255 |
| Collectively evaluated for impairment |  |  | 191,689 |  |  | 23,782 |  |  | 124,244 |  |  | 244,533 |  |  | 528,541 |  |  | 31,474 |  |  | — |  |  | 1,144,263 |
| **Total** |  | $ | 193,267 |  | $ | 23,782 |  | $ | 124,389 |  | $ | 248,435 |  | $ | 530,010 |  | $ | 31,635 |  | $ | — |  | $ | 1,151,518 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **December 31, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Allowance for loan losses:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Individually evaluated for impairment |  | $ | 551 |  | $ | — |  | $ | — |  | $ | 579 |  | $ | 37 |  | $ | 27 |  | $ | — |  | $ | 1,194 |
| Collectively evaluated for impairment |  |  | 2,686 |  |  | 140 |  |  | 757 |  |  | 1,492 |  |  | 4,877 |  |  | 307 |  |  | 199 |  |  | 10,458 |
| **Total** |  | $ | 3,237 |  | $ | 140 |  | $ | 757 |  | $ | 2,071 |  | $ | 4,914 |  | $ | 334 |  | $ | 199 |  | $ | 11,652 |
| **Loans outstanding:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Individually evaluated for impairment |  | $ | 2,428 |  | $ | — |  | $ | 153 |  | $ | 4,793 |  | $ | 850 |  | $ | 254 |  | $ | — |  | $ | 8,478 |
| Collectively evaluated for impairment |  |  | 205,292 |  |  | 28,610 |  |  | 106,631 |  |  | 236,724 |  |  | 528,686 |  |  | 32,206 |  |  | — |  |  | 1,138,149 |
| **Total** |  | $ | 207,720 |  | $ | 28,610 |  | $ | 106,784 |  | $ | 241,517 |  | $ | 529,536 |  | $ | 32,460 |  | $ | — |  | $ | 1,146,627 |

*Impaired Loans*

Loans evaluated under ASC 310‑10‑35 include loans which are individually evaluated for impairment. All other loans are collectively evaluated for impairment under ASC 450‑20. Impaired loans individually evaluated for impairment totaled $7.3 million and $8.5 million at September 30, 2019 and December 31, 2018, respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings (TDRs).

The net carrying value of impaired loans is based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At September 30, 2019, $2.9 million of impaired loans were evaluated based on the fair value less estimated selling costs of the loans' collateral compared to $3.8 million at December 31, 2018. Once the impairment amount is calculated, a specific reserve allocation is recorded. At September 30, 2019, $708,000 of the Company’s allowance for loan losses was allocated to impaired loans totaling $7.3 million compared to $1.2 million of the Company’s allowance for loan losses allocated to impaired loans totaling approximately $8.5 million at December 31, 2018. Management determined that $1.6 million, or 23%, of total impaired loans required no reserve allocation at September 30, 2019 compared to $2.1 million, or 25%, at December 31, 2018, primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

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The categories of impaired loans at September 30, 2019 and December 31, 2018 are as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |
| *(in thousands)* |  | **2019** | |  | **2018** | |
| Non-accrual and non-performing TDRs |  | $ | 4,623 |  | $ | 5,414 |
| Performing TDRs |  |  | 2,632 |  |  | 3,064 |
| **Total impaired loans** |  | $ | 7,255 |  | $ | 8,478 |

The following tables provide additional information about impaired loans at September 30, 2019 and December 31, 2018, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided.

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **Unpaid** | |  |  |  |
|  |  | **Recorded** | |  | **Principal** | |  | **Specific** | |
| *(in thousands)* |  | **Investment** | |  | **Balance** | |  | **Reserves** | |
| **September 30, 2019** |  |  |  |  |  |  |  |  |  |
| **With no related allowance recorded:** |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 496 |  | $ | 837 |  | $ | — |
| Real estate - construction commercial |  |  | 145 |  |  | 177 |  |  | — |
| Real estate - residential |  |  | 606 |  |  | 684 |  |  | — |
| Real estate - commercial |  |  | 377 |  |  | 394 |  |  |  |
| Installment and other consumer |  |  | 13 |  |  | 13 |  |  | — |
| **Total** |  | $ | 1,637 |  | $ | 2,105 |  | $ | — |
| **With an allowance recorded:** |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 1,082 |  | $ | 1,163 |  | $ | 361 |
| Real estate - residential |  |  | 3,296 |  |  | 3,635 |  |  | 296 |
| Real estate - commercial |  |  | 1,092 |  |  | 1,219 |  |  | 34 |
| Installment and other consumer |  |  | 148 |  |  | 176 |  |  | 17 |
| **Total** |  | $ | 5,618 |  | $ | 6,193 |  | $ | 708 |
| **Total impaired loans** |  | $ | 7,255 |  | $ | 8,298 |  | $ | 708 |

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| --- |
|  |

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|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **Unpaid** | |  |  |  |
|  |  | **Recorded** | |  | **Principal** | |  | **Specific** | |
| *(in thousands)* |  | **Investment** | |  | **Balance** | |  | **Reserves** | |
| **December 31, 2018** |  |  |  |  |  |  |  |  |  |
| **With no related allowance recorded:** |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 1,264 |  | $ | 1,550 |  | $ | — |
| Real estate - construction commercial |  |  | 153 |  |  | 180 |  |  | — |
| Real estate - residential |  |  | 561 |  |  | 602 |  |  | — |
| Real estate - commercial |  |  | 115 |  |  | 119 |  |  | — |
| **Total** |  | $ | 2,093 |  | $ | 2,451 |  | $ | — |
| **With an allowance recorded:** |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 1,164 |  | $ | 1,236 |  | $ | 551 |
| Real estate - residential |  |  | 4,232 |  |  | 4,458 |  |  | 579 |
| Real estate - commercial |  |  | 735 |  |  | 1,093 |  |  | 37 |
| Installment and other consumer |  |  | 254 |  |  | 280 |  |  | 27 |
| **Total** |  | $ | 6,385 |  | $ | 7,067 |  | $ | 1,194 |
| **Total impaired loans** |  | $ | 8,478 |  | $ | 9,518 |  | $ | 1,194 |

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | | | | | | | |  | **Nine Months Ended September 30,** | | | | | | | | | | |
|  |  | **2019** | | | | |  | **2018** | | | | |  | **2019** | | | | |  | **2018** | | | | |
|  |  |  |  |  | **Interest** | |  |  |  |  | **Interest** | |  |  |  |  | **Interest** | |  |  |  |  | **Interest** | |
|  |  | **Average** | |  | **Recognized** | |  | **Average** | |  | **Recognized** | |  | **Average** | |  | **Recognized** | |  | **Average** | |  | **Recognized** | |
|  |  | **Recorded** | |  | **For the** | |  | **Recorded** | |  | **For the** | |  | **Recorded** | |  | **For the** | |  | **Recorded** | |  | **For the** | |
| *(in thousands)* |  | **Investment** | |  | **Period Ended** | |  | **Investment** | |  | **Period Ended** | |  | **Investment** | |  | **Period Ended** | |  | **Investment** | |  | **Period Ended** | |
| **With no related allowance recorded:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 851 |  | $ | — |  | $ | 1,375 |  | $ | — |  | $ | 1,036 |  | $ | — |  | $ | 1,334 |  | $ | 1 |
| Real estate - construction commercial |  |  | 146 |  |  | — |  |  | 161 |  |  | — |  |  | 149 |  |  | — |  |  | 82 |  |  | — |
| Real estate - residential |  |  | 1,301 |  |  | — |  |  | 1,037 |  |  | 3 |  |  | 651 |  |  | — |  |  | 929 |  |  | 9 |
| Real estate - commercial |  |  | 380 |  |  | — |  |  | 120 |  |  | 3 |  |  | 393 |  |  | — |  |  | 30 |  |  | 22 |
| Installment and other consumer |  |  | 4 |  |  | — |  |  | 91 |  |  | — |  |  | 3 |  |  | — |  |  | 34 |  |  | — |
| **Total** |  | $ | 2,682 |  | $ | — |  | $ | 2,784 |  | $ | 6 |  | $ | 2,232 |  | $ | — |  | $ | 2,409 |  | $ | 32 |
| **With an allowance recorded:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 1,086 |  | $ | 9 |  | $ | 1,423 |  | $ | 8 |  | $ | 1,095 |  | $ | 30 |  | $ | 1,507 |  | $ | 23 |
| Real estate - construction residential |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |  |  | 15 |  |  | — |
| Real estate - construction commercial |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |  |  | 24 |  |  | — |
| Real estate - residential |  |  | 2,818 |  |  | 21 |  |  | 4,076 |  |  | 25 |  |  | 3,881 |  |  | 68 |  |  | 4,211 |  |  | 71 |
| Real estate - commercial |  |  | 1,112 |  |  | 9 |  |  | 1,443 |  |  | 13 |  |  | 788 |  |  | 25 |  |  | 1,649 |  |  | 24 |
| Installment and other consumer |  |  | 188 |  |  | 1 |  |  | 197 |  |  | — |  |  | 221 |  |  | 2 |  |  | 186 |  |  | 1 |
| **Total** |  | $ | 5,204 |  | $ | 40 |  | $ | 7,139 |  | $ | 46 |  | $ | 5,985 |  | $ | 125 |  | $ | 7,592 |  | $ | 119 |
| **Total impaired loans** |  | $ | 7,886 |  | $ | 40 |  | $ | 9,923 |  | $ | 52 |  | $ | 8,217 |  | $ | 125 |  | $ | 10,001 |  | $ | 151 |

The recorded investment varies from the unpaid principal balance primarily due to partial charge-offs taken resulting from current appraisals received. The amount recognized as interest income on impaired loans continuing to accrue interest, primarily related to troubled debt restructurings, was $40,000 and $125,000 for the three and nine months ended September

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30, 2019, respectively, compared to $52,000 and $151,000 for the three and nine months ended September 30, 2018, respectively. The average recorded investment in impaired loans is calculated on a monthly basis during the periods reported.

*Delinquent and Non-Accrual Loans*

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

The following table provides aging information for the Company’s past due and non-accrual loans at September 30, 2019 and December 31, 2018.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Current or** | |  |  |  |  | **90 Days** | |  |  |  |  |  |  |
|  |  | **Less Than** | |  |  |  |  | **Past Due** | |  |  |  |  |  |  |
|  |  | **30 Days** | |  | **30 - 89 Days** | |  | **And Still** | |  |  |  |  |  |  |
| *(in thousands)* |  | **Past Due** | |  | **Past Due** | |  | **Accruing** | |  | **Non-Accrual** | |  | **Total** | |
| **September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, Financial, and Agricultural |  | $ | 192,142 |  | $ | 98 |  | $ | — |  | $ | 1,027 |  | $ | 193,267 |
| Real Estate Construction - Residential |  |  | 23,782 |  |  | — |  |  | — |  |  | — |  |  | 23,782 |
| Real Estate Construction - Commercial |  |  | 124,177 |  |  | 67 |  |  | — |  |  | 145 |  |  | 124,389 |
| Real Estate Mortgage - Residential |  |  | 245,379 |  |  | 705 |  |  | 193 |  |  | 2,158 |  |  | 248,435 |
| Real Estate Mortgage - Commercial |  |  | 528,539 |  |  | 360 |  |  | — |  |  | 1,111 |  |  | 530,010 |
| Installment and Other Consumer |  |  | 31,402 |  |  | 106 |  |  | 4 |  |  | 123 |  |  | 31,635 |
| **Total** |  | $ | 1,145,421 |  | $ | 1,336 |  | $ | 197 |  | $ | 4,564 |  | $ | 1,151,518 |
| **December 31, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, Financial, and Agricultural |  | $ | 205,597 |  | $ | 266 |  | $ | — |  | $ | 1,857 |  | $ | 207,720 |
| Real Estate Construction - Residential |  |  | 28,404 |  |  | 206 |  |  | — |  |  | — |  |  | 28,610 |
| Real Estate Construction - Commercial |  |  | 106,531 |  |  | 100 |  |  | — |  |  | 153 |  |  | 106,784 |
| Real Estate Mortgage - Residential |  |  | 235,734 |  |  | 2,907 |  |  | 156 |  |  | 2,720 |  |  | 241,517 |
| Real Estate Mortgage - Commercial |  |  | 527,968 |  |  | 1,094 |  |  | — |  |  | 474 |  |  | 529,536 |
| Installment and Other Consumer |  |  | 32,002 |  |  | 242 |  |  | 6 |  |  | 210 |  |  | 32,460 |
| **Total** |  | $ | 1,136,236 |  | $ | 4,815 |  | $ | 162 |  | $ | 5,414 |  | $ | 1,146,627 |

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*Credit Quality*

The Company categorizes loans into risk categories based upon an internal rating system reflecting management’s risk assessment. Loans are placed on *watch* status when one or more weaknesses are identified that may result in the borrower being unable to meet repayment terms or the Company’s credit position could deteriorate at some future date. Loans classified as *substandard* are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Loans so classified may have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. Such loans are characterized by the distinct possibility that the Company may sustain some loss if the deficiencies are not corrected. A loan is classified as a *troubled debt restructuring*  (*TDR)* when a borrower is experiencing financial difficulties that lead to the restructuring of a loan, and the Company grants concessions to the borrower in the restructuring that it would not otherwise consider. Loans classified as TDRs that are accruing interest are classified as performing TDRs. Loans classified as TDRs, that are not accruing interest are classified as nonperforming TDRs and are included with all other nonaccrual loans for presentation purposes. It is the Company’s policy to discontinue the accrual of interest income on loans when management believes that the collection of interest or principal is doubtful.

The following table presents the risk categories by class at September 30, 2019 and December 31, 2018.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Commercial,** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Real Estate** | |  | **Installment** | |  |  |  |
|  |  | **Financial, &** | |  | **Construction -** | |  | **Construction -** | |  | **Mortgage -** | |  | **Mortgage -** | |  | **and other** | |  |  |  |
| *(in thousands)* |  | **Agricultural** | |  | **Residential** | |  | **Commercial** | |  | **Residential** | |  | **Commercial** | |  | **Consumer** | |  | **Total** | |
| **At September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Watch |  | $ | 13,083 |  | $ | 679 |  | $ | 7,172 |  | $ | 14,453 |  | $ | 36,393 |  | $ | — |  | $ | 71,780 |
| Substandard |  |  | 1,257 |  |  | — |  |  | — |  |  | 1,336 |  |  | 685 |  |  | 3 |  |  | 3,281 |
| Performing TDRs |  |  | 551 |  |  | — |  |  | — |  |  | 1,685 |  |  | 358 |  |  | 38 |  |  | 2,632 |
| Non-accrual and non-performing TDRs |  |  | 1,027 |  |  | — |  |  | 145 |  |  | 2,217 |  |  | 1,111 |  |  | 123 |  |  | 4,623 |
| **Total** |  | $ | 15,918 |  | $ | 679 |  | $ | 7,317 |  | $ | 19,691 |  | $ | 38,547 |  | $ | 164 |  | $ | 82,316 |
| **At December 31, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Watch |  | $ | 8,871 |  | $ | 588 |  | $ | 4,063 |  | $ | 12,790 |  | $ | 36,408 |  | $ | 8 |  | $ | 62,728 |
| Substandard |  |  | 53 |  |  | — |  |  | — |  |  | 1,411 |  |  | 702 |  |  | 3 |  |  | 2,169 |
| Performing TDRs |  |  | 570 |  |  | — |  |  | — |  |  | 2,073 |  |  | 377 |  |  | 44 |  |  | 3,064 |
| Non-accrual and non-performing TDRs |  |  | 1,857 |  |  | — |  |  | 153 |  |  | 2,720 |  |  | 474 |  |  | 210 |  |  | 5,414 |
| **Total** |  | $ | 11,351 |  | $ | 588 |  | $ | 4,216 |  | $ | 18,994 |  | $ | 37,961 |  | $ | 265 |  | $ | 73,375 |

*Troubled Debt Restructurings*

At September 30, 2019, loans classified as TDRs totaled $4.0 million, of which $1.4 million were classified as non-performing TDRs and $2.6 million were classified as performing TDRs. At December 31, 2018, loans classified as TDRs totaled $5.0 million, of which $2.0 million were classified as non-performing TDRs and $3.0 million were classified as performing TDRs. Both performing and nonperforming TDRs are considered impaired loans. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan’s effective interest rate or the fair value of the underlying collateral less applicable selling costs. Accordingly, specific reserves of $471,000 and $543,000 related to TDRs were allocated to the allowance for loan losses at September 30, 2019 and December 31, 2018, respectively.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | | | | | | | | | | | |
|  |  | **2019** | | | | | | |  | **2018** | | | | | | |
|  |  | **Recorded Investment (1)** | | | | | | |  | **Recorded Investment (1)** | | | | | | |
|  |  | **Number of** |  | **Pre-** | |  | **Post-** | |  | **Number of** |  | **Pre-** | |  | **Post-** | |
| *(in thousands)* |  | **Contracts** |  | **Modification** | |  | **Modification** | |  | **Contracts** |  | **Modification** | |  | **Modification** | |
| **Troubled Debt Restructurings** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | — |  | $ | — |  | $ | — |  | 2 |  | $ | 353 |  | $ | 353 |
| Installment and other consumer |  | — |  |  | — |  |  | — |  | 1 |  |  | 112 |  |  | 53 |
| **Total** |  | — |  | $ | — |  | $ | — |  | 3 |  | $ | 465 |  | $ | 406 |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Nine Months Ended September 30,** | | | | | | | | | | | | | | |
|  |  | **2019** | | | | | | |  | **2018** | | | | | | |
|  |  | **Recorded Investment (1)** | | | | | | |  | **Recorded Investment (1)** | | | | | | |
|  |  | **Number of** |  | **Pre-** | |  | **Post-** | |  | **Number of** |  | **Pre-** | |  | **Post-** | |
| *(in thousands)* |  | **Contracts** |  | **Modification** | |  | **Modification** | |  | **Contracts** |  | **Modification** | |  | **Modification** | |
| **Troubled Debt Restructurings** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | 2 |  | $ | 80 |  | $ | 76 |  | 2 |  | $ | 353 |  | $ | 353 |
| Real estate mortgage - residential |  | — |  |  | — |  |  | — |  | 1 |  |  | 75 |  |  | 74 |
| Installment and other consumer |  | — |  |  | — |  |  | — |  | 5 |  |  | 160 |  |  | 3 |
| **Total** |  | 2 |  | $ | 80 |  | $ | 76 |  | 8 |  | $ | 588 |  | $ | 430 |

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

The Company’s portfolio of loans classified as TDRs include concessions for the borrower given financial condition such as interest rates below the current market rate, deferring principal payments, and extending maturity dates. There were no loans and two loans meeting the TDR criteria that were modified during the three and nine months ended September 30, 2019, compared to three and eight loans during the three and nine months ended September 30, 2018.

The Company considers a TDR to be in default when it is 90 days or more past due under the modified terms, a charge-off occurs, or it is the process of foreclosure. There was one loan and no loans modified as a TDR that defaulted during any of the three and nine months ended September 30, 2019 and 2018, respectively, and within twelve months of their modification date.  See *Lending and Credit Management* section for further information.

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**(3)   Other Real Estate Acquired in Settlement of Loans**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |
| *(in thousands)* |  | **2019** | |  | **2018** | |
| Commercial |  | $ | 1,155 |  | $ | 1,168 |
| Real estate construction - residential |  |  | — |  |  | 179 |
| Real estate construction - commercial |  |  | 11,553 |  |  | 12,101 |
| Real estate mortgage - residential |  |  | 286 |  |  | 336 |
| Real estate mortgage - commercial |  |  | 2,871 |  |  | 2,909 |
| Total |  | $ | 15,865 |  | $ | 16,693 |
| Less valuation allowance for other real estate owned |  |  | (2,987) |  |  | (3,002) |
| **Total other real estate owned** |  | $ | 12,878 |  | $ | 13,691 |

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | |  | **Nine Months Ended September 30,** | | | | |  |
|  |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| **Balance at beginning of period** |  | $ | 16,066 |  | $ | 16,453 |  | $ | 16,693 |  | $ | 16,598 |  |
| Additions |  |  | 68 |  |  | 207 |  |  | 411 |  |  | 589 |  |
| Proceeds from sales |  |  | (352) |  |  | (68) |  |  | (1,277) |  |  | (372) |  |
| Charge-offs against the valuation allowance for other real estate owned, net |  |  | — |  |  | (20) |  |  | (64) |  |  | (245) |  |
| Net gain (loss) on sales |  |  | 83 |  |  | (2) |  |  | 102 |  |  | — |  |
| Total other real estate owned |  | $ | 15,865 |  | $ | 16,570 |  | $ | 15,865 |  | $ | 16,570 |  |
| Less valuation allowance for other real estate owned |  |  | (2,987) |  |  | (3,002) |  |  | (2,987) |  |  | (3,002) |  |
| **Balance at end of period** |  | $ | 12,878 |  | $ | 13,568 |  | $ | 12,878 |  | $ | 13,568 |  |

At September 30, 2019,  $252,000 of consumer mortgage loans secured by residential real estate properties were in the process of foreclosure compared to $200,000 of consumer mortgage loans at December 31, 2018.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | |  | **Nine Months Ended September 30,** | | | | |  |
| *(in thousands)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| **Balance, beginning of period** |  | $ | 2,956 |  | $ | 3,022 |  | $ | 3,002 |  | $ | 3,221 |  |
| Provision for other real estate owned |  |  | 31 |  |  | — |  |  | 49 |  |  | 26 |  |
| Charge-offs |  |  | — |  |  | (20) |  |  | (64) |  |  | (245) |  |
| **Balance, end of period** |  | $ | 2,987 |  | $ | 3,002 |  | $ | 2,987 |  | $ | 3,002 |  |

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**(4)   Investment Securities**

*Available for sale securities*

The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2019 and December 31, 2018 were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Total** | |  |  |  |  |  |  |  |  |  |
|  |  | **Amortized** | |  | **Gross Unrealized** | | | | |  | **Fair** | |
| (*in thousands)* |  | **Cost** | |  | **Gains** | |  | **Losses** | |  | **Value** | |
| **September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 985 |  | $ | 10 |  | $ | — |  | $ | 995 |
| U.S. government and federal agency obligations |  |  | 8,495 |  |  | — |  |  | (30) |  |  | 8,465 |
| Government sponsored enterprises |  |  | 22,786 |  |  | 50 |  |  | (38) |  |  | 22,798 |
| Obligations of states and political subdivisions |  |  | 29,341 |  |  | 144 |  |  | (61) |  |  | 29,424 |
| Mortgage-backed securities |  |  | 115,261 |  |  | 542 |  |  | (569) |  |  | 115,234 |
| Other debt securities (a) |  |  | 3,000 |  |  | 51 |  |  | — |  |  | 3,051 |
| Bank issued trust preferred securities (a) |  |  | 1,486 |  |  | — |  |  | (183) |  |  | 1,303 |
| **Total available-for-sale securities** |  | $ | 181,354 |  | $ | 797 |  | $ | (881) |  | $ | 181,270 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| **December 31, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 1,984 |  | $ | — |  | $ | (32) |  | $ | 1,952 |
| U.S. government and federal agency obligations |  |  | 10,235 |  |  | — |  |  | (269) |  |  | 9,966 |
| Government sponsored enterprises |  |  | 43,784 |  |  | 23 |  |  | (472) |  |  | 43,335 |
| Obligations of states and political subdivisions |  |  | 40,859 |  |  | 28 |  |  | (501) |  |  | 40,386 |
| Mortgage-backed securities |  |  | 121,230 |  |  | 72 |  |  | (3,110) |  |  | 118,192 |
| Other debt securities (a) |  |  | 3,000 |  |  | — |  |  | — |  |  | 3,000 |
| Bank issued trust preferred securities (a) |  |  | 1,486 |  |  | — |  |  | (112) |  |  | 1,374 |
| **Total available-for-sale securities** |  | $ | 222,578 |  | $ | 123 |  | $ | (4,496) |  | $ | 218,205 |

(a) Certain hybrid instruments possessing characteristics typically associated with debt obligations.

The Company’s investment securities are classified as available for sale. Agency bonds and notes, Small Business Administration guaranteed loan certificates (SBA), residential and commercial agency mortgage-backed securities, and agency collateralized mortgage obligations (CMO) include securities issued by the Government National Mortgage Association (GNMA), a U.S. government agency, and the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal Home Loan Bank (FHLB), which are U.S. government-sponsored enterprises.

Debt securities with carrying values aggregating approximately $117.9 million and $153.0 million at September 30, 2019 and December 31, 2018, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

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The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2019, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without prepayment penalties.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **Amortized** | |  | **Fair** | |
| (*in thousands)* |  | **Cost** | |  | **Value** | |
| Due in one year or less |  | $ | 8,962 |  | $ | 8,951 |
| Due after one year through five years |  |  | 36,227 |  |  | 36,256 |
| Due after five years through ten years |  |  | 10,910 |  |  | 10,926 |
| Due after ten years |  |  | 9,994 |  |  | 9,903 |
| Total |  |  | 66,093 |  |  | 66,036 |
| Mortgage-backed securities |  |  | 115,261 |  |  | 115,234 |
| **Total available-for-sale securities** |  | $ | 181,354 |  | $ | 181,270 |

*Other securities*

Other investment securities include equity securities with readily determinable fair values and other investment securities that do not have readily determinable fair values. Investments in Federal Home Loan Bank (FHLB) stock, and Midwest Independent Bank (MIB) bankers bank stock, that do not have readily determinable fair values, are required for membership in those organizations.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
| *(in thousands)* |  | **September 30, 2019** | |  | **December 31, 2018** | |
| **Other securities:** |  |  |  |  |  |  |
| FHLB stock |  | $ | 6,046 |  | $ | 5,512 |
| MIB stock |  |  | 151 |  |  | 151 |
| Equity securities with readily determinable fair values |  |  | 13 |  |  | 12 |
| **Total other investment securities** |  | $ | 6,210 |  | $ | 5,675 |

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Gross unrealized losses on debt securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2019 and December 31, 2018 were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Less than 12 months** | | | | |  | **12 months or more** | | | | |  | **Total** | |  | **Total** | |
|  |  | **Fair** | |  | **Unrealized** | |  | **Fair** | |  | **Unrealized** | |  | **Fair** | |  | **Unrealized** | |
| *(in thousands)* |  | **Value** | |  | **Losses** | |  | **Value** | |  | **Losses** | |  | **Value** | |  | **Losses** | |
| **At September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | — |  | $ | — |  | $ | — |  | $ | — |  | $ | — |  | $ | — |
| U.S. government and federal agency obligations |  |  | 6,310 |  |  | (25) |  |  | 1,913 |  |  | (5) |  |  | 8,223 |  |  | (30) |
| Government sponsored enterprises |  |  | 4,539 |  |  | (6) |  |  | 8,466 |  |  | (32) |  |  | 13,005 |  |  | (38) |
| Obligations of states and political subdivisions |  |  | 9,098 |  |  | (45) |  |  | 2,891 |  |  | (16) |  |  | 11,989 |  |  | (61) |
| Mortgage-backed securities |  |  | 8,624 |  |  | (24) |  |  | 46,968 |  |  | (545) |  |  | 55,592 |  |  | (569) |
| Other debt securities |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |
| Bank issued trust preferred securities |  |  | — |  |  | — |  |  | 1,303 |  |  | (183) |  |  | 1,303 |  |  | (183) |
| **Total** |  | $ | 28,571 |  | $ | (100) |  | $ | 61,541 |  | $ | (781) |  | $ | 90,112 |  | $ | (881) |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **At December 31, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | — |  | $ | — |  | $ | 1,952 |  | $ | (32) |  | $ | 1,952 |  | $ | (32) |
| U.S. government and federal agency obligations |  |  | — |  |  | — |  |  | 9,966 |  |  | (269) |  |  | 9,966 |  |  | (269) |
| Government sponsored enterprises |  |  | 1,997 |  |  | (3) |  |  | 33,346 |  |  | (469) |  |  | 35,343 |  |  | (472) |
| Obligations of states and political subdivisions |  |  | 5,851 |  |  | (16) |  |  | 28,832 |  |  | (485) |  |  | 34,683 |  |  | (501) |
| Mortgage-backed securities |  |  | 10,085 |  |  | (61) |  |  | 99,321 |  |  | (3,049) |  |  | 109,406 |  |  | (3,110) |
| Bank issued trust preferred securities |  |  | — |  |  | — |  |  | 1,374 |  |  | (112) |  |  | 1,374 |  |  | (112) |
| **Total** |  | $ | 17,933 |  | $ | (80) |  | $ | 174,791 |  | $ | (4,416) |  | $ | 192,724 |  | $ | (4,496) |

The total available for sale portfolio consisted of approximately 314 securities at September 30, 2019. The portfolio included 144 securities having an aggregate fair value of $90.1 million that were in a loss position at September 30, 2019. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled $61.5 million at fair value at September 30, 2019. The $881,000 aggregate unrealized loss included in accumulated other comprehensive loss at September 30, 2019 was caused by interest rate fluctuations.

The total available for sale portfolio consisted of approximately 366 securities at December 31, 2018. The portfolio included 317 securities having an aggregate fair value of $192.7 million that were in a loss position at December 31, 2018. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled $174.8 million at fair value at December 31, 2018. The $4.5 million aggregate unrealized loss included in accumulated other comprehensive loss at December 31, 2018 was caused by interest rate fluctuations.

Because the decline in fair value is attributable to changes in interest rates and not credit quality, these investments were not considered other-than-temporarily impaired at September 30, 2019 and December 31, 2018, respectively. In the absence of changes in credit quality of these investments, the fair value is expected to recover on all debt securities as they approach their maturity date or re-pricing date, or if market yields for such investments decline. In addition, the Company does not have the intent to sell these investments over the period of recovery, and it is not more likely than not that the Company will be required to sell such investment securities.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | |  | **Nine Months Ended September 30,** | | | | |
| *(in thousands)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |
| ***Investment securities (losses) gains, net*** |  |  |  |  |  |  |  |  |  |  |  |  |
| **Available for sale securities:** |  |  |  |  |  |  |  |  |  |  |  |  |
| Gains realized on sales |  | $ | 6 |  | $ | 47 |  | $ | 6 |  | $ | 253 |
| Losses realized on sales |  |  | (46) |  |  | — |  |  | (46) |  |  | — |
| Other-than-temporary impairment recognized |  |  | — |  |  | — |  |  | — |  |  | — |
| **Other investment securities:** |  |  |  |  |  |  |  |  |  |  |  |  |
| Fair value adjustments, net |  |  | — |  |  | 3 |  |  | — |  |  | 3 |
| **Investment securities (losses) gains, net** |  | **$** | **(40)** |  | **$** | **50** |  | **$** | **(40)** |  | **$** | **256** |

During the three and nine months ended September 30, 2019, the Company received $21.5 million from the proceeds from the sale of available for sale debt securities. During the three and nine months ended September 30, 2018, the Company received $25.4 million and $77.2 million, respectively, from proceeds from a series of short-term sales of U.S. Treasury securities purchased with repurchase agreements, and recognized gains of $47,000 and $253,000, respectively, in order to generate capital gains to offset capital losses that were to expire during 2018 and 2019.

**(5)   Intangible Assets**

*Mortgage Servicing Rights*

At September 30, 2019, the Company was servicing approximately $270.8 million of loans sold to the secondary market compared to $279.9 million at December 31, 2018, and $282.9 million at September 30, 2018. Mortgage loan servicing fees, reported in real estate servicing fees, net, earned on loans sold were $205,000 and $581,000 for the three and nine months ended September 30, 2019, respectively, compared to $201,000 and $614,000 for the three and nine months ended September 30, 2018, respectively.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | |  | **Nine Months Ended September 30,** | | | | |
| *(in thousands)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |
| **Balance at beginning of period** |  | $ | 2,657 |  | $ | 2,813 |  | $ | 2,931 |  | $ | 2,713 |
| Originated mortgage servicing rights |  |  | 88 |  |  | 66 |  |  | 187 |  |  | 198 |
| Changes in fair value: |  |  |  |  |  |  |  |  |  |  |  |  |
| Due to changes in model inputs and assumptions (1) |  |  | (77) |  |  | 70 |  |  | (318) |  |  | 203 |
| Other changes in fair value (2) |  |  | (93) |  |  | (78) |  |  | (225) |  |  | (243) |
| Total changes in fair value |  |  | (170) |  |  | (8) |  |  | (543) |  |  | (40) |
| **Balance at end of period** |  | $ | 2,575 |  | $ | 2,871 |  | $ | 2,575 |  | $ | 2,871 |

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

(2)Other changes in fair value, reported in real estate servicing fees, net, reflect changes due to customer payments and passage of time.

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The following key data and assumptions were used in estimating the fair value of the Company’s MSRs as of September 30, 2019 and 2018, respectively:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
|  | **Nine Months Ended September 30,** | | | | |
|  |  | **2019** |  | **2018** |  |
| Weighted average constant prepayment rate |  | 13.27 | % | 9.36 | % |
| Weighted average note rate |  | 3.95 | % | 3.92 | % |
| Weighted average discount rate |  | 8.75 | % | 10.36 | % |
| Weighted average expected life (in years) |  | 4.8 |  | 6.1 |  |

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(in thousands)* |  | **2019** | |  | **2018** | |  |
| Federal funds purchased |  | $ | — |  | $ | 8,000 |  |
| Repurchase agreements |  |  | 27,191 |  |  | 16,647 |  |
| Total |  | $ | 27,191 |  | $ | 24,647 |  |

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Repurchase Agreements** |  | **Remaining Contractual Maturity of the Agreements** | | | | | | | | | | |
|  |  | **Overnight** | |  | **Less** | |  | **Greater** | |  |  |  |
|  |  | **and** | |  | **than** | |  | **than** | |  |  |  |
| *(in thousands)* |  | **continuous** | |  | **90 days** | |  | **90 days** | |  | **Total** | |
| **At September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 756 |  | $ | — |  | $ | — |  | $ | 756 |
| Government sponsored enterprises |  |  | 9,364 |  |  | — |  |  | — |  |  | 9,364 |
| Asset-backed securities |  |  | 17,071 |  |  | — |  |  | — |  |  | 17,071 |
| **Total** |  | $ | 27,191 |  | $ | — |  | $ | — |  | $ | 27,191 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| **At December 31, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 1,464 |  | $ | — |  | $ | — |  | $ | 1,464 |
| Government sponsored enterprises |  |  | 12,976 |  |  | — |  |  | — |  |  | 12,976 |
| Asset-backed securities |  |  | 2,207 |  |  | — |  |  | — |  |  | 2,207 |
| **Total** |  | $ | 16,647 |  | $ | — |  | $ | — |  | $ | 16,647 |

**(7)   Leases**

The Company's leases primarily consist of office space and bank branches with remaining lease terms of generally 1 to 10 years. As of September 30, 2019, operating ROU assets and liabilities were $2.3 million and $2.3 million, respectively.

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As of September 30, 2019, the weighted-average remaining lease term on these operating leases is approximately 8.7 years and the weighted-average discount rate used to measure the lease liabilities is approximately 4.0%.

Operating leases in which the Company is the lessee are recorded as operating lease right-of-use assets and operating lease liabilities. Currently, the Company does not have any finance leases. The ROU assets are included in premises and equipment, net on the consolidated balance sheets.

Operating lease right-of-use assets represent the Company's right to use an underlying asset during the lease term and operating lease liabilities represent the Company's obligation to make lease payments arising from the lease. Right-of-use assets and operating lease liabilities are recognized at lease commencement based on the present value of the remaining lease payments using a discount rate that represents the Company's incremental borrowing rate at the lease commencement date.

Operating lease cost, which is comprised of amortization of the right-of-use asset and the implicit interest accreted on the operating lease liability, is recognized on a straight-line basis over the lease term, and is recorded in net occupancy expense in the consolidated statements of income. The operating lease cost for the three and nine months ended September 30, 2019 was $86,000 and $202,000,  respectively.

At adoption of ASU 2016-02 on January 1, 2019, lease and non-lease components of new lease agreements are accounted for separately. Lease components include fixed payments including rent, real estate taxes and insurance costs and non-lease components include common-area maintenance costs. Leases with an initial term of 12 months or less are not recorded on the balance sheet; the Company recognizes lease expense for these leases on a straight-line basis over the lease term. Operating lease expense for these leases was $20,000 and $71,000 for the three and nine months ended September 30, 2019, respectively, compared to $41,000 and $127,000 for the three and nine months ended September 30, 2018, respectively.

The table below summarizes the maturity of remaining operating lease liabilities:

|  |  |  |  |
| --- | --- | --- | --- |
|  |  |  |  |
|  |  | **Operating** | |
| **Lease payments due in:** |  | **Lease** | |
| *(in thousands)* |  |  |  |
| 2019 (excluding nine months ended September 30, 2019) |  | $ | 83 |
| 2020 |  |  | 334 |
| 2021 |  |  | 317 |
| 2022 |  |  | 310 |
| 2023 |  |  | 312 |
| Thereafter |  |  | 1,345 |
| Total lease payments |  |  | 2,701 |
| Less imputed interest |  |  | (416) |
| Total lease liabilities, as reported |  | $ | 2,285 |
|  |  |  |  |

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**(8)   Income Taxes**

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 19.8% and 19.3% for the three and nine months ended September 30, 2019, respectively, compared to 12.6% and 11.8% for the three and nine months ended September 30, 2018, respectively.

The change in the effective tax rate for both the three and nine months ended September 30, 2019 over the three and nine months ended September 30, 2018, was primarily due to the final impacts of the Tax Cuts and Jobs Act which decreased the 2018 tax rate. In addition, the 2019 tax rate increased due to additional taxable income, which included a $2.2 million pre-tax gain from the sale of the Branson branch. Without the impact of these items, the year-to-date 2018 and 2019 tax rates would have been approximately 17.0% and 18.8%, respectively.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income of the appropriate character during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning initiatives in making this assessment. In management's opinion, the Company will more likely than not realize the benefits of its deferred tax assets and, therefore, has not established a valuation allowance against its deferred tax assets as of September 30, 2019. Management arrived at this conclusion based upon the level of historical taxable income and projections for future taxable income of the appropriate character over the periods in which the deferred tax assets are deductible. The Company follows ASC Topic 740, Income Taxes, which addresses the accounting for uncertain tax positions. For each of the three and nine months ended September 30, 2019 and 2018, respectively, the Company did not have any uncertain tax provisions, and did not record any related tax liabilities.

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**(9)   Stockholders’ Equity**

*Accumulated Other Comprehensive Loss*

The following details the change in the components of the Company’s accumulated other comprehensive loss for the nine months ended September 30, 2019 and 2018:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |
|  |  | **Nine Months Ended September 30, 2019** | | | | | | | |
|  |  |  |  |  |  |  |  | **Accumulated** | |
|  |  |  |  |  | **Unrecognized Net** | |  | **Other** | |
|  |  | **Unrealized** | |  | **Pension and** | |  | **Comprehensive** | |
|  |  | **Gain (Loss)** | |  | **Postretirement** | |  | **(Loss)** | |
| *(in thousands)* |  | **on Securities (1)** | |  | **Costs (2)** | |  | **Income** | |
| **Balance at beginning of period** |  | $ | (3,455) |  | $ | (2,644) |  | $ | (6,099) |
| Other comprehensive income, before reclassifications |  |  | 4,250 |  |  | 58 |  |  | 4,308 |
| Amounts reclassified from accumulated other comprehensive (loss) income |  |  | 40 |  |  | — |  |  | 40 |
| Current period other comprehensive income, before tax |  |  | 4,290 |  |  | 58 |  |  | 4,348 |
| Income tax expense |  |  | (901) |  |  | (12) |  |  | (913) |
| Current period other comprehensive income, net of tax |  |  | 3,389 |  |  | 46 |  |  | 3,435 |
| **Balance at end of period** |  | $ | (66) |  | $ | (2,598) |  | $ | (2,664) |

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |
|  |  | **Nine Months Ended September 30, 2018** | | | | | | | |
|  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **Unrecognized Net** | |  | **Accumulated** | |
|  |  | **Unrealized** | |  | **Pension and** | |  | **Other** | |
|  |  | **Gain (Loss)** | |  | **Postretirement** | |  | **Comprehensive** | |
| *(in thousands)* |  | **on Securities (1)** | |  | **Costs (2)** | |  | **Loss** | |
| **Balance at beginning of period** |  | $ | (2,500) |  | $ | (3,162) |  | $ | (5,662) |
| Other comprehensive (loss) income, before reclassifications |  |  | (3,915) |  |  | 164 |  |  | (3,751) |
| Amounts reclassified from accumulated other comprehensive (loss) income |  |  | — |  |  | — |  |  | — |
| Current period other comprehensive (loss) income, before tax |  |  | (3,915) |  |  | 164 |  |  | (3,751) |
| Income tax benefit (expense) |  |  | 822 |  |  | (35) |  |  | 787 |
| Current period other comprehensive (loss) income, net of tax |  |  | (3,093) |  |  | 129 |  |  | (2,964) |
| **Balance at end of period** |  | $ | (5,593) |  | $ | (3,033) |  | $ | (8,626) |

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

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

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**(10)   Employee Benefit Plans**

*Employee Benefits*

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | |  | **Nine Months Ended September 30,** | | | | |  |
| *(in thousands)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| Payroll taxes |  | $ | 256 |  | $ | 261 |  | $ | 871 |  | $ | 913 |  |
| Medical plans |  |  | 432 |  |  | 490 |  |  | 1,359 |  |  | 1,650 |  |
| 401(k) match and profit sharing |  |  | 349 |  |  | 261 |  |  | 929 |  |  | 684 |  |
| Periodic pension cost |  |  | 358 |  |  | 470 |  |  | 1,073 |  |  | 1,280 |  |
| Other |  |  | 15 |  |  | 12 |  |  | 40 |  |  | 37 |  |
| **Total employee benefits** |  | $ | 1,410 |  | $ | 1,494 |  | $ | 4,272 |  | $ | 4,564 |  |

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

*Other Plans*

On November 7, 2018, the Board of Directors of the Company adopted a supplemental executive retirement plan (SERP) which became effective on January 1, 2018. The SERP provides select employees who satisfy certain eligibility requirements with certain benefits upon retirement, termination of employment or death.

As of September 30, 2019, the accrued liability was $560,000 and the expense for the three and nine months ended September 30, 2019 was $80,000 and $240,000,  respectively, and is recognized over the required service period. After the plan was adopted in November 2018, $320,000 was accrued and recognized over the required service period.

*Pension*

The Company provides a noncontributory defined benefit pension plan for all full-time employees. Beginning January 1, 2018 and for all retrospective periods presented, the Company adopted the guidance under ASU 2017‑07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. Under the new guidance, only the service cost component of the net periodic benefit cost is reported in the same income statement line item as salaries and benefits, and the remaining components are reported as other non-interest expense. An employer is required to recognize the funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. Under the Company’s funding policy for the defined benefit pension plan, contributions are made to a trust as necessary to provide for current service and for any unfunded accrued actuarial liabilities over a reasonable period. To the extent that these requirements are fully covered by assets in the trust, a contribution might not be made in a particular year. The Company made a pension contribution of $1.6 million on April 17, 2019. Effective July 1, 2017, the Company amended the pension plan to effectuate a “soft freeze” such that no individual hired (or rehired in the case of a former employee) by the Company after September 30, 2017, whether or not such individual is or was a vested member in the plan, will be eligible to be an active member and be entitled to accrue any benefits under the plan.

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

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **Pension Benefits** | | | | |  |
| *(in thousands)* |  | **2019** | |  | **2018** | |  |
| Service cost - benefits earned during the year |  | $ | 1,431 |  | $ | 1,707 |  |
| Interest costs on projected benefit obligations (a) |  |  | 1,168 |  |  | 1,037 |  |
| Expected return on plan assets (a) |  |  | (1,467) |  |  | (1,327) |  |
| Expected administrative expenses (a) |  |  | 122 |  |  | 93 |  |
| Amortization of prior service cost (a) |  |  | 79 |  |  | 79 |  |
| Amortization of unrecognized net loss (a) |  |  | — |  |  | 140 |  |
| **Net periodic pension cost** |  | $ | 1,333 |  | $ | 1,729 |  |
|  |  |  |  |  |  |  |  |
| Net periodic pension cost for the three months ended September 30, (actual) |  | $ | 358 |  | $ | 470 |  |
| Net periodic pension cost for the nine months ended September 30, (actual) |  | $ | 1,073 |  | $ | 1,280 |  |

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

Net periodic pension benefit costs include interest costs based on an assumed discount rate, the expected return on plan assets based on actuarially derived market-related values, and the amortization of net actuarial losses. Net periodic postretirement benefit costs include service costs, interest costs based on an assumed discount rate, and the amortization of prior service credits and net actuarial gains. Differences between expected and actual results in each year are included in the net actuarial gain or loss amount, which is recognized in other comprehensive income. The net actuarial gain or loss in excess of a 10% corridor is amortized in net periodic benefit cost over the average remaining service period of active participants in the Plans. The prior service credit is amortized over the average remaining service period to full eligibility for participating employees expected to receive benefits.

**(11)   Earnings per Share**

***Stock Dividend*** On July 1, 2019, the Company paid a special stock dividend of 4% to common shareholders of record at the close of business on June 15, 2019. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

Basic earnings per share is computed by dividing income available to shareholders by the weighted average number of shares outstanding during the year. Diluted earnings per share gives effect to all dilutive potential shares that were outstanding during the year.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | |  | **Nine Months Ended September 30,** | | | | |  |
| *(dollars in thousands, except per share data)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| **Basic earnings per share:** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net income available to shareholders |  | $ | 3,860 |  | $ | 3,098 |  | $ | 12,046 |  | $ | 8,095 |  |
| Average shares outstanding |  |  | 6,276,236 |  |  | 6,264,200 |  |  | 6,276,236 |  |  | 6,265,290 |  |
| **Basic earnings per share** |  | $ | 0.62 |  | $ | 0.49 |  | $ | 1.92 |  | $ | 1.29 |  |
| **Diluted earnings per share:** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net income available to shareholders |  | $ | 3,860 |  | $ | 3,098 |  | $ | 12,046 |  | $ | 8,095 |  |
| Average shares outstanding |  |  | 6,276,236 |  |  | 6,264,200 |  |  | 6,276,236 |  |  | 6,265,290 |  |
| Effect of dilutive stock options |  |  | — |  |  | 6,617 |  |  | — |  |  | 6,740 |  |
| Average shares outstanding including dilutive stock options |  |  | 6,276,236 |  |  | 6,270,817 |  |  | 6,276,236 |  |  | 6,272,030 |  |
| **Diluted earnings per share** |  | $ | 0.62 |  |  | 0.49 |  | $ | 1.92 |  |  | 1.29 |  |

Under the treasury stock method, outstanding stock options are dilutive when the average market price of the Company’s common stock, when combined with the effect of any unamortized compensation expense, exceeds the option price during the period, except when the Company has a loss from continuing operations available to shareholders. In addition, proceeds from the assumed exercise of dilutive options along with the related tax benefit are assumed to be used to repurchase common shares at the average market price of such stock during the period. There were no outstanding stock options for any of the three and nine months ended September 30, 2019 and 2018, respectively, that were omitted from the computation of diluted earnings per share as a result of being considered anti-dilutive.

On September 18, 2019, the Company's Board of Directors authorized the purchase of up to $5.0 million market value of the Company's common stock. Management was given discretion to determine the number and pricing of the shares to be purchased, as well as, the timing of any such purchases. During the three months ended September 30, 2019, no shares of the Company's common stock were purchased by or on behalf of the Company or affiliated purchasers.

**(12)   Fair Value Measurements**

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

Depending on the nature of the asset or liability, the Company uses various valuation methodologies and assumptions to estimate fair value. The measurement of fair value under US GAAP uses a hierarchy intended to maximize the use of observable inputs and minimize the use of unobservable inputs. This hierarchy uses three levels of inputs to measure the fair value of assets and liabilities as follows. During the nine months ended September 30, 2019 and the year ended December 31, 2018, respectively, there were no transfers into or out of Levels 1‑3.

The fair value hierarchy is as follows:

Level 1 – Inputs are unadjusted quoted prices for identical assets or liabilities in active markets. A quoted price in an active market provides the most reliable evidence of fair value and is used to measure fair value whenever available. A contractually binding sales price also provides reliable evidence of fair value.

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

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

In accordance with fair value accounting guidance, the Company measures, records, and reports various types of assets and liabilities at fair value on either a recurring or non-recurring basis in the Consolidated Financial Statements. Nonfinancial assets measured at fair value on a nonrecurring basis would include foreclosed real estate, long-lived assets, and core deposit intangible assets, which are reviewed when circumstances or other events indicate that impairment may have occurred.

***Valuation Methods for Assets and Liabilities Measured at Fair Value on a Recurring Basis***

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

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

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

Equity securities with readily determinable fair values are recorded at fair value, with changes in fair value reflected in earnings. The Company uses level 1 inputs to value equity securities that are traded in active markets. Equity securities that do not have readily determinable fair values are carried at cost and are periodically assessed for impairment. Equity securities that are not actively traded are classified in level 2.

***Mortgage Servicing Rights***

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

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rates, and other ancillary income, including late fees. The valuation models estimate the present value of estimated future net servicing income. The Company classifies its servicing rights as Level 3.

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **Fair Value Measurements** | | | | | | | |
|  |  |  |  |  | **Quoted Prices** | |  |  |  |  |  |  |
|  |  |  |  |  | **in Active** | |  |  |  |  |  |  |
|  |  |  |  |  | **Markets for** | |  | **Other** | |  | **Significant** | |
|  |  |  |  |  | **Identical** | |  | **Observable** | |  | **Unobservable** | |
|  |  |  |  |  | **Assets** | |  | **Inputs** | |  | **Inputs** | |
| *(in thousands)* |  | **Fair Value** | |  | **(Level 1)** | |  | **(Level 2)** | |  | **(Level 3)** | |
| **September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 995 |  | $ | 995 |  |  | — |  | $ | — |
| U.S. government and federal agency obligations |  |  | 8,465 |  |  | — |  |  | 8,465 |  |  | — |
| Government sponsored enterprises |  |  | 22,798 |  |  | — |  |  | 22,798 |  |  | — |
| Obligations of states and political subdivisions |  |  | 29,424 |  |  | — |  |  | 29,424 |  |  | — |
| Mortgage-backed securities |  |  | 115,234 |  |  | — |  |  | 115,234 |  |  | — |
| Other debt securities |  |  | 3,051 |  |  | — |  |  | 3,051 |  |  | — |
| Bank-issued trust preferred securities |  |  | 1,303 |  |  | — |  |  | 1,303 |  |  | — |
| Equity securities |  |  | 13 |  |  | 13 |  |  | — |  |  | — |
| Mortgage servicing rights |  |  | 2,575 |  |  | — |  |  | — |  |  | 2,575 |
| **Total** |  | $ | 183,858 |  | $ | 1,008 |  | $ | 180,275 |  | $ | 2,575 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| **December 31, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 1,952 |  | $ | 1,952 |  |  | — |  | $ | — |
| U.S. government and federal agency obligations |  |  | 9,966 |  |  | — |  |  | 9,966 |  |  | — |
| Government sponsored enterprises |  |  | 43,335 |  |  | — |  |  | 43,335 |  |  | — |
| Obligations of states and political subdivisions |  |  | 40,386 |  |  | — |  |  | 40,386 |  |  | — |
| Mortgage-backed securities |  |  | 118,192 |  |  | — |  |  | 118,192 |  |  | — |
| Other debt securities |  |  | 3,000 |  |  | — |  |  | 3,000 |  |  | — |
| Bank-issued trust preferred securities |  |  | 1,374 |  |  | — |  |  | 1,374 |  |  | — |
| Equity securities |  |  | 12 |  |  | 12 |  |  | — |  |  | — |
| Mortgage servicing rights |  |  | 2,931 |  |  | — |  |  | — |  |  | 2,931 |
| **Total** |  | $ | 221,148 |  | $ | 1,964 |  | $ | 216,253 |  | $ | 2,931 |

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Fair Value Measurements Using** | | | | |  | **Fair Value Measurements Using** | | | | |  |
|  |  | **Significant Unobservable Inputs** | | | | |  | **Significant Unobservable Inputs** | | | | |  |
|  |  | **(Level 3)** | | | | |  | **(Level 3)** | | | | |  |
|  |  | **Mortgage Servicing Rights** | | | | |  | **Mortgage Servicing Rights** | | | | |  |
|  |  | **Three Months Ended September 30,** | | | | |  | **Nine Months Ended September 30,** | | | | |  |
| *(in thousands)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| Balance at beginning of period |  | $ | 2,657 |  | $ | 2,813 |  | $ | 2,931 |  | $ | 2,713 |  |
| Total (losses) or gains (realized/unrealized): |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Included in earnings |  |  | (170) |  |  | (8) |  |  | (543) |  |  | (40) |  |
| Included in other comprehensive income |  |  | — |  |  | — |  |  | — |  |  | — |  |
| Purchases |  |  | — |  |  | — |  |  | — |  |  | — |  |
| Sales |  |  | — |  |  | — |  |  | — |  |  | — |  |
| Issues |  |  | 88 |  |  | 66 |  |  | 187 |  |  | 198 |  |
| Settlements |  |  | — |  |  | — |  |  | — |  |  | — |  |
| Balance at end of period |  | $ | 2,575 |  | $ | 2,871 |  | $ | 2,575 |  | $ | 2,871 |  |

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

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

*Collateral dependent impaired loans*

While the overall loan portfolio is not carried at fair value, the Company periodically records nonrecurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Nonrecurring adjustments also include certain impairment amounts for collateral dependent loans when establishing the allowance for loan losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan. In determining the value of real estate collateral, the Company relies on external and internal appraisals of property values depending on the size and complexity of the real estate collateral. The Company maintains staff that is trained to perform in-house evaluations and also review third party appraisal reports for reasonableness. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgments based on the experience and expertise of internal specialists. Values of all loan collateral are regularly reviewed by senior loan committee. Because many of these inputs are not observable, the measurements are classified as Level 3. As of September, 2019, the Company identified $2.9 million in collateral dependent impaired loans that had specific allowances for losses aggregating $398,000. Related to these loans, there were $77,000 and $204,000 in charge-offs recorded during the three and nine months ended September 30, 2019, respectively. As of September 30, 2018, the Company identified $4.2 million in collateral dependent impaired loans that had specific allowances for losses aggregating $891,000. Related to these loans, there were $53,000 and $303,000 in charge-offs recorded during the three and nine months ended September 30, 2018, respectively.

*Other Real Estate and Foreclosed Assets*

Other real estate owned (OREO) and foreclosed assets consisted of loan collateral that has been repossessed through foreclosure. This collateral is comprised of commercial and residential real estate and other non-real estate property,

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including autos, manufactured homes, and construction equipment. Subsequent to foreclosure, these assets initially are carried at fair value of the collateral less estimated selling costs. Fair value, when recorded, is generally based upon appraisals by approved, independent state certified appraisers. Like impaired loans, appraisals on OREO may be discounted based on the Company’s historical knowledge, changes in market conditions from the time of appraisal or other information available. During the holding period, valuations are updated periodically, and the assets may be written down to reflect a new cost basis. Because many of these inputs are not observable, the measurements are classified as Level 3.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **Fair Value Measurements Using** | | | | | | | | | | | | | |
|  |  |  |  |  | **Quoted Prices** | |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **in Active** | |  |  |  |  |  |  |  | **Three Months** | |  | **Nine Months** | |
|  |  |  |  |  | **Markets for** | |  | **Other** | |  | **Significant** | |  | **Ended** | |  | **Ended** | |
|  |  |  |  |  | **Identical** | |  | **Observable** | |  | **Unobservable** | |  | **September 30,** | |  | **September 30,** | |
|  |  | **Total** | |  | **Assets** | |  | **Inputs** | |  | **Inputs** | |  | **Total Gains** | |  | **Total Gains** | |
| *(in thousands)* |  | **Fair Value** | |  | **(Level 1)** | |  | **(Level 2)** | |  | **(Level 3)** | |  | **(Losses)\*** | |  | **(Losses)\*** | |
| **September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Collateral dependent impaired loans: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, & agricultural |  | $ | 529 |  | $ | — |  | $ | — |  | $ | 529 |  | $ | (22) |  | $ | (132) |
| Real estate construction - commercial |  |  | 145 |  |  | — |  |  | — |  |  | 145 |  |  | — |  |  | — |
| Real estate mortgage - residential |  |  | 933 |  |  | — |  |  | — |  |  | 933 |  |  | (45) |  |  | (45) |
| Real estate mortgage - commercial |  |  | 860 |  |  | — |  |  | — |  |  | 860 |  |  | (6) |  |  | (15) |
| Installment and other consumer |  |  | 13 |  |  | — |  |  | — |  |  | 13 |  |  | (4) |  |  | (12) |
| Total |  | $ | 2,480 |  | $ | — |  | $ | — |  | $ | 2,480 |  | $ | (77) |  | $ | (204) |
| Other real estate and repossessed assets |  | $ | 12,878 |  | $ | — |  | $ | — |  | $ | 12,878 |  | $ | 10 |  | $ | (166) |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **September 30, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Collateral dependent impaired loans: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, & agricultural |  | $ | 1,549 |  | $ | — |  | $ | — |  | $ | 1,549 |  | $ | (21) |  | $ | (187) |
| Real estate construction - commercial |  |  | 158 |  |  | — |  |  | — |  |  | 158 |  |  | — |  |  | (27) |
| Real estate mortgage - residential |  |  | 1,156 |  |  | — |  |  | — |  |  | 1,156 |  |  | (32) |  |  | (44) |
| Real estate mortgage - commercial |  |  | 399 |  |  | — |  |  | — |  |  | 399 |  |  | — |  |  | (20) |
| Installment and other consumer |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |  |  | (25) |
| Total |  | $ | 3,262 |  | $ | — |  | $ | — |  | $ | 3,262 |  | $ | (53) |  | $ | (303) |
| Other real estate and repossessed assets |  | $ | 13,373 |  | $ | — |  | $ | — |  | $ | 13,373 |  | $ | (3) |  | $ | (29) |

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

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**(13)   Fair Value of Financial Instruments**

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

***Loans***

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

***Investment Securities***

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

***Other investment securities***

Other investment securities include equity securities with readily determinable fair values and other investment securities that do not have readily determinable fair values. Investments in Federal Home Loan Bank (FHLB) stock, and Midwest Independent Bank (MIB) bankers bank stock, that do not have readily determinable fair values, are required for membership in those organizations. Equity securities that are not actively traded are classified in level 2.

Equity securities with readily determinable fair values are recorded at fair value, with changes in fair value reflected in earnings. Equity securities that do not have readily determinable fair values are carried at cost and are periodically assessed for impairment. The Company uses level 1 inputs to value equity securities that are traded in active markets.

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

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

***Certificates of Deposit in other banks***

Certificates of deposit are other investments made by the Company with other financial institutions that are carried at cost which is equal to fair value.

***Cash Surrender Value - Life Insurance***

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

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***Accrued Interest Receivable and Payable***

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

***Deposits***

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

***Federal funds purchased and Securities Sold under Agreements to Repurchase***

For Federal funds purchased and securities sold under agreements to repurchase, the carrying amount is a reasonable estimate of fair value, as such instruments reprice in a short time period.

***Subordinated Notes and Other Borrowings***

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

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A summary of the carrying amounts and fair values of the Company’s financial instruments at September 30, 2019 and December 31, 2018 is as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **September 30, 2019** | | | | | | | |
|  |  |  |  |  |  |  |  | **Fair Value Measurements** | | | | | | | |
|  |  |  |  |  |  |  |  |  | **Quoted Prices** |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **in Active** | |  |  |  |  | **Net** | |
|  |  |  |  |  |  |  |  | **Markets for** | |  | **Other** | |  | **Significant** | |
|  |  | **September 30, 2019** | | | | |  | **Identical** | |  | **Observable** | |  | **Unobservable** | |
|  |  | **Carrying** | |  | **Fair** | |  | **Assets** | |  | **Inputs** | |  | **Inputs** | |
| *(in thousands)* |  | **amount** | |  | **value** | |  | **(Level 1)** | |  | **(Level 2)** | |  | **(Level 3)** | |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Cash and due from banks |  | $ | 22,856 |  | $ | 22,856 |  | $ | 22,856 |  | $ | — |  | $ | — |
| Federal funds sold and overnight interest-bearing deposits |  |  | 21,559 |  |  | 21,559 |  |  | 21,559 |  |  | — |  |  | — |
| Certificates of deposit in other banks |  |  | 11,601 |  |  | 11,601 |  |  | 11,601 |  |  | — |  |  | — |
| Available for sale securities |  |  | 181,270 |  |  | 181,270 |  |  | 995 |  |  | 180,275 |  |  | — |
| Other investment securities |  |  | 6,210 |  |  | 6,210 |  |  | 13 |  |  | 6,197 |  |  | — |
| Loans, net |  |  | 1,139,340 |  |  | 1,132,835 |  |  | — |  |  | — |  |  | 1,132,835 |
| Mortgage servicing rights |  |  | 2,575 |  |  | 2,575 |  |  | — |  |  | — |  |  | 2,575 |
| Cash surrender value - life insurance |  |  | 2,385 |  |  | 2,385 |  |  | — |  |  | 2,385 |  |  | — |
| Accrued interest receivable |  |  | 6,215 |  |  | 6,215 |  |  | 6,215 |  |  | — |  |  | — |
|  |  | $ | 1,394,011 |  | $ | 1,387,506 |  | $ | 63,239 |  | $ | 188,857 |  | $ | 1,135,410 |
| **Liabilities:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Deposits: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Non-interest bearing demand |  | $ | 284,452 |  | $ | 284,452 |  | $ | 284,452 |  | $ | — |  | $ | — |
| Savings, interest checking and money market |  |  | 550,350 |  |  | 550,350 |  |  | 550,350 |  |  | — |  |  | — |
| Time deposits |  |  | 302,605 |  |  | 303,092 |  |  | — |  |  | — |  |  | 303,092 |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 27,191 |  |  | 27,191 |  |  | 27,191 |  |  | — |  |  | — |
| Federal Home Loan Bank advances and other borrowings |  |  | 106,980 |  |  | 93,751 |  |  | — |  |  | 93,751 |  |  | — |
| Subordinated notes |  |  | 49,486 |  |  | 43,393 |  |  | — |  |  | 43,393 |  |  | — |
| Operating lease liabilities |  |  | 2,285 |  |  | 2,285 |  |  |  |  |  | 2,285 |  |  |  |
| Accrued interest payable |  |  | 1,020 |  |  | 1,020 |  |  | 1,020 |  |  | — |  |  | — |
|  |  | $ | 1,324,369 |  | $ | 1,305,534 |  | $ | 863,013 |  | $ | 139,429 |  | $ | 303,092 |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **December 31, 2018** | | | | | | | |
|  |  |  |  |  |  |  |  | **Fair Value Measurements** | | | | | | | |
|  |  |  |  |  |  |  |  | **Quoted Prices** | |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **in Active** | |  |  |  |  | **Net** | |
|  |  |  |  |  |  |  |  | **Markets for** | |  | **Other** | |  | **Significant** | |
|  |  | **December 31, 2018** | | | | |  | **Identical** | |  | **Observable** | |  | **Unobservable** | |
|  |  | **Carrying** | |  | **Fair** | |  | **Assets** | |  | **Inputs** | |  | **Inputs** | |
| *(in thousands)* |  | **amount** | |  | **value** | |  | **(Level 1)** | |  | **(Level 2)** | |  | **(Level 3)** | |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Cash and due from banks |  | $ | 23,687 |  | $ | 23,687 |  | $ | 23,687 |  | $ | — |  | $ | — |
| Federal funds sold and overnight interest-bearing deposits |  |  | 18,396 |  |  | 18,396 |  |  | 18,396 |  |  | — |  |  | — |
| Certificates of deposit in other banks |  |  | 12,247 |  |  | 12,247 |  |  | 12,247 |  |  | — |  |  | — |
| Available-for-sale securities |  |  | 218,205 |  |  | 218,205 |  |  | 1,952 |  |  | 216,253 |  |  | — |
| Other investment securities |  |  | 5,675 |  |  | 5,675 |  |  | 12 |  |  | 5,663 |  |  | — |
| Loans, net |  |  | 1,134,975 |  |  | 1,115,003 |  |  | — |  |  | — |  |  | 1,115,003 |
| Mortgage servicing rights |  |  | 2,931 |  |  | 2,931 |  |  | — |  |  | — |  |  | 2,931 |
| Cash surrender value - life insurance |  |  | 2,542 |  |  | 2,542 |  |  | — |  |  | 2,542 |  |  | — |
| Accrued interest receivable |  |  | 6,162 |  |  | 6,162 |  |  | 6,162 |  |  | — |  |  | — |
|  |  | $ | 1,424,820 |  | $ | 1,404,848 |  | $ | 62,456 |  | $ | 224,458 |  | $ | 1,117,934 |
| **Liabilities:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Deposits: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Non-interest bearing demand |  | $ | 262,857 |  | $ | 262,857 |  | $ | 262,857 |  | $ | — |  | $ | — |
| Savings, interest checking and money market |  |  | 614,040 |  |  | 614,040 |  |  | 614,040 |  |  | — |  |  | — |
| Time deposits |  |  | 321,571 |  |  | 318,949 |  |  | — |  |  | — |  |  | 318,949 |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 24,647 |  |  | 24,647 |  |  | 24,647 |  |  | — |  |  | — |
| Federal Home Loan Bank advances and other borrowings |  |  | 95,153 |  |  | 94,326 |  |  | — |  |  | 94,326 |  |  | — |
| Subordinated notes |  |  | 49,486 |  |  | 45,749 |  |  | — |  |  | 45,749 |  |  | — |
| Accrued interest payable |  |  | 1,035 |  |  | 1,035 |  |  | 1,035 |  |  | — |  |  | — |
|  |  | $ | 1,368,789 |  | $ | 1,361,603 |  | $ | 902,579 |  | $ | 140,075 |  | $ | 318,949 |

***Off-Balance Sheet Financial Instruments***

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

***Limitations***

The fair value estimates provided are made at a point in time based on market information and information about the financial instruments. Because no market exists for a portion of the Company’s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and

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involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the fair value estimates.

**(14)   Commitments and Contingencies**

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

The Company’s extent of involvement and maximum potential exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for financial instruments included on its consolidated balance sheets. At September 30, 2019, no amounts have been accrued for any estimated losses for these financial instruments.

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(in thousands)* |  | **2019** | |  | **2018** | |  |
| Commitments to extend credit |  | $ | 246,058 |  | $ | 267,314 |  |
| Commitments to originate residential first and second mortgage loans |  |  | 9,582 |  |  | 1,759 |  |
| Standby letters of credit |  |  | 70,250 |  |  | 82,895 |  |
| **Total** |  |  | 325,890 |  |  | 351,968 |  |

***Commitments***

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

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These standby letters of credit are primarily issued to support contractual obligations of the Company’s customers. The approximate remaining term of standby letters of credit range from one month to five years at September 30, 2019.

***Pending Litigation***

The Company and its subsidiaries are defendants in various legal actions incidental to the Company’s past and current business activities. Based on the Company’s analysis, and considering the inherent uncertainties associated with litigation, management does not believe that it is reasonably possible that these legal actions will materially adversely affect the Company’s consolidated financial condition or results of operations in the near term. The Company records a loss accrual

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for all legal matters for which it deems a loss is probable and can be reasonably estimated. Some legal matters, which are at early stages in the legal process, have not yet progressed to the point where a loss is deemed probable or an amount can be estimated.

**(15)   Revenue Recognition**

On January 1, 2018, the Company adopted ASU No. 2014‑09, *Revenue from Contracts with Customers (Topic 606)* and all subsequent ASUs that modified Topic 606.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, derivatives, and certain credit card fees are not in the scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as trust department revenue, service charges and fees, debit card income, ATM surcharge income, and sales of other real estate owned. However, the recognition of these revenue streams did not change current business practices or result in any changes to the Company’s consolidated financial statements.

Descriptions of our revenue-generating activities within the scope of this guidance, which are presented in our income statement as components of noninterest income are as follows:

|  |  |  |  |
| --- | --- | --- | --- |
|  | · |  | Service charges on deposit accounts - represents fees generated from a variety of deposit products and services provided to customers under a day-to-day contract. These fees are recognized on a daily or monthly basis. |

|  |  |  |  |
| --- | --- | --- | --- |
|  | · |  | Bank card income and fees – represents fees, exchange, and other service charge revenue earned from merchant, debit and credit cards that are recognized when the services are rendered or upon completion. These fees are recognized on a daily or monthly basis. |

|  |  |  |  |
| --- | --- | --- | --- |
|  | · |  | Gain on sale of other real estate - represents income recognized at the time of control of a property is transferred to the buyer. |

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

***Forward-Looking Statements***

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

|  |  |  |  |
| --- | --- | --- | --- |
|  | · |  | statements that are not historical in nature, and |

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

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

|  |  |  |  |
| --- | --- | --- | --- |
|  | · |  | competitive pressures among financial services companies may increase significantly, |

|  |  |  |  |
| --- | --- | --- | --- |
|  | · |  | changes in the interest rate environment may reduce interest margins, |

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|  | · |  | 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, |

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|  | · |  | increases in non-performing assets in the Company’s loan portfolios and adverse economic conditions may necessitate increases to our provisions for loan losses, |

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

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|  | · |  | legislative, regulatory or tax law changes may adversely affect the business in which the Company and its subsidiaries are engaged, and |

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|  | · |  | changes may occur in the securities markets. |

We have described under the caption *Risk Factors* in the Company’s Annual Report on Form 10‑K for the year ended December 31, 2018, and in other reports filed with the SEC from time to time, additional factors that could cause actual results to be materially different from those described in the forward-looking statements. Other factors that have not been identified in this report could also have this effect. You are cautioned not to put undue reliance on any forward-looking statement, which speak only as of the date they were made.

***Overview***

Crucial to the Company’s community banking strategy is growth in its commercial banking services, retail mortgage lending and retail banking services. Through the branch network of its subsidiary bank, the Company, with $1.4 billion in assets at September 30, 2019, provides a broad range of commercial and personal banking services. The Bank’s specialties include commercial banking for small and mid-sized businesses, including equipment, operating, commercial real estate, Small Business Administration (SBA) loans, and personal banking services including real estate mortgage lending, installment and consumer loans, certificates of deposit, individual retirement and other time deposit accounts, checking accounts, savings accounts, and money market accounts. Other financial services that the Company provides include trust services that include estate planning, investment and asset management services and a comprehensive suite of cash management services. The geographic areas in which the Company provides products and services include the Missouri communities in and surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, and the greater Kansas City metropolitan area.

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

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

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

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

**CRITICAL ACCOUNTING POLICIES**

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

***Allowance for Loan Losses***

Management has identified the accounting policy related to the allowance for loan losses as critical to the understanding of the Company’s results of operations, since the application of this policy requires significant management assumptions and estimates that could result in materially different amounts to be reported if conditions or underlying circumstances were to change. Further discussion of the methodology used in establishing the allowance and the impact of any associated risks related to these policies on the Company’s business operations is provided in note 1 to the Company’s unaudited consolidated financial statements and is also discussed in the *Lending and Credit Management* section below. Many of the loans are deemed collateral dependent for purposes of the measurement of the impairment loss, thus the fair value of the underlying collateral and sensitivity of such fair values due to changing market conditions, supply and demand, condition of the collateral and other factors can be volatile over periods of time. Such volatility can have an impact on the financial performance of the Company.

**SELECTED CONSOLIDATED FINANCIAL DATA**

The following table presents selected consolidated financial information for the Company as of and for each of the three and nine months ended September 30, 2019 and 2018, respectively. The selected consolidated financial data should

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be read in conjunction with the unaudited consolidated financial statements of the Company, including the related notes, presented elsewhere herein.

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| **Selected Financial Data** |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended** | | | | |  | **Nine Months Ended** | | | | |  |
|  |  | **September 30,** | | | | |  | **September 30,** | | | | |  |
| **(In thousands, except per share data)** |  |  | **2019** |  |  | **2018** |  |  | **2019** |  |  | **2018** |  |
| **Per Share Data** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Basic earnings per share |  | $ | 0.62 |  | $ | 0.49 |  | $ | 1.92 |  | $ | 1.29 |  |
| Diluted earnings per share |  |  | 0.62 |  |  | 0.49 |  |  | 1.92 |  |  | 1.29 |  |
| Cash dividends paid on common stock |  |  | 724 |  |  | 579 |  |  | 1,931 |  |  | 1,390 |  |
| Common stock dividend |  |  | 5,795 |  |  | 5,014 |  |  | 5,795 |  |  | 5,014 |  |
| Book value per share |  |  |  |  |  |  |  |  | 17.97 |  |  | 15.14 |  |
| Market price per share |  |  |  |  |  |  |  |  | 23.83 |  |  | 21.88 |  |
| **Selected Ratios** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| ***(Based on average balance sheets)*** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Return on total assets |  |  | 1.07 | % |  | 0.85 | % |  | 1.09 | % |  | 0.75 | % |
| Return on stockholders' equity |  |  | 13.72 | % |  | 13.02 | % |  | 15.03 | % |  | 11.69 | % |
| Stockholders' equity to total assets |  |  | 7.79 | % |  | 6.50 | % |  | 7.22 | % |  | 6.42 | % |
| Efficiency ratio (1) |  |  | 64.86 | % |  | 72.62 | % |  | 68.13 | % |  | 75.23 | % |
| Net interest spread |  |  | 3.32 | % |  | 3.05 | % |  | 3.15 | % |  | 3.06 | % |
| Net interest margin |  |  | 3.64 | % |  | 3.31 | % |  | 3.47 | % |  | 3.29 | % |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| ***(Based on end-of-period data)*** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Stockholders' equity to assets |  |  |  |  |  |  |  |  | 7.78 | % |  | 6.54 | % |
| Total risk-based capital ratio |  |  |  |  |  |  |  |  | 14.47 | % |  | 13.54 | % |
| Tier 1 risk-based capital ratio |  |  |  |  |  |  |  |  | 12.60 | % |  | 11.31 | % |
| Common equity Tier 1 capital |  |  |  |  |  |  |  |  | 9.50 | % |  | 8.60 | % |
| Tier 1 leverage ratio (2) |  |  |  |  |  |  |  |  | 10.69 | % |  | 9.35 | % |

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

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

**Use of Non-GAAP Measures**

Several financial measures in this report are non-GAAP, meaning they are not presented in accordance with generally accepted accounting principles (GAAP) in the U.S. The non-GAAP items presented in this report are non-GAAP net income, non-GAAP basic earnings per share, non-GAAP diluted earnings per share, non-GAAP return on average assets and non-GAAP return on average common equity. These measures include the adjustment to exclude the impact of the gain on the sale of our Branson branch that closed during the first quarter of 2019, which is non-recurring and not considered indicative of underlying earnings performance. The Company believes that the exclusion of this item provides a useful basis for evaluating the Company's underlying performance, but should not be considered in isolation and is not in accordance with, or a substitute for, evaluating performance utilizing GAAP financial information. The Company uses non-GAAP measures to analyze its financial performance and to make financial comparisons to prior periods presented on a similar basis. The Company believes that providing such adjusted results allows investors to better understand the Company's comparative operating performance for the periods presented. Non-GAAP measures are not formally defined by GAAP or codified in the federal banking regulations, and other entities may use calculation methods that differ from those used by the Company. The Company has reconciled each of these measures to a comparable GAAP measure below:

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| **Income Statement Data** |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended** | | | | |  | **Nine Months Ended** | | | | |  |
|  |  | **September 30,** | | | | |  | **September 30,** | | | | |  |
| (*In thousands, except per share data)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| Net income - GAAP |  | $ | 3,860 |  | $ | 3,098 |  | $ | 12,046 |  | $ | 8,095 |  |
| Effect of net gain on branch sale (a) |  |  | (86) |  |  | — |  |  | (1,725) |  |  | — |  |
| Net income - non-GAAP |  | $ | 3,774 |  | $ | 3,098 |  | $ | 10,321 |  | $ | 8,095 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Per Share Data** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Basic earnings per share - GAAP |  | $ | 0.62 |  | $ | 0.49 |  | $ | 1.92 |  | $ | 1.29 |  |
| Effect of net gain on branch sale (a) |  |  | (0.01) |  |  | — |  |  | (0.27) |  |  | — |  |
| Basic earnings per share - non-GAAP |  | $ | 0.61 |  | $ | 0.49 |  | $ | 1.65 |  | $ | 1.29 |  |
| Diluted earnings per share - GAAP |  | $ | 0.62 |  | $ | 0.49 |  | $ | 1.92 |  | $ | 1.29 |  |
| Effect of net gain on branch sale (a) |  |  | (0.01) |  |  | — |  |  | (0.27) |  |  | — |  |
| Diluted earnings per share - non-GAAP |  | $ | 0.61 |  | $ | 0.49 |  | $ | 1.65 |  | $ | 1.29 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Key Ratios** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Return on average total assets - GAAP |  |  | 1.07 | % |  | 0.85 | % |  | 1.09 | % |  | 0.75 | % |
| Effect of net gain on branch sale (a) |  |  | (0.02) | % |  | — | % |  | (0.16) | % |  | — | % |
| Return on average total assets - non-GAAP |  |  | 1.05 | % |  | 0.85 | % |  | 0.93 | % |  | 0.75 | % |
| Return on average stockholders' equity - GAAP |  |  | 13.72 | % |  | 13.02 | % |  | 15.03 | % |  | 11.69 | % |
| Effect of net gain on branch sale (a) |  |  | (0.31) | % |  | — | % |  | (2.15) | % |  | — | % |
| Return on average stockholders' equity - non-GAAP |  |  | 13.41 | % |  | 13.02 | % |  | 12.88 | % |  | 11.69 | % |

(a) The gain on the sale of the Branson Branch was $0.1 million pre-tax and $0.1 million after tax for the three months ended September 30, 2019 and $2.2 million pre-tax and $1.7 million after tax for the nine months ended September 30, 2019.

**RESULTS OF OPERATIONS ANALYSIS**

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

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|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | | | | | | | |  | **Nine Months Ended September 30,** | | | | | | | | | | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  | **$ Change** | |  | **% Change** | |  | **2019** | |  | **2018** | |  | **$ Change** | |  | **% Change** | |  |
| Net interest income |  | $ | 12,361 |  | $ | 11,308 |  | $ | 1,053 |  |  | 9.3 | % | $ | 36,147 |  | $ | 33,090 |  | $ | 3,057 |  |  | 9.2 | % |
| Provision for loan losses |  |  | 450 |  |  | 250 |  |  | 200 |  |  | 80.0 |  |  | 850 |  |  | 1,000 |  |  | (150) |  |  | (15.0) |  |
| Non-interest income |  |  | 2,424 |  |  | 2,364 |  |  | 60 |  |  | 2.5 |  |  | 6,637 |  |  | 6,970 |  |  | (333) |  |  | (4.8) |  |
| Investment securities (losses) gains, net |  |  | (40) |  |  | 50 |  |  | (90) |  |  | (180.0) |  |  | (40) |  |  | 256 |  |  | (296) |  |  | (115.6) |  |
| Gain on branch sale, net |  |  | 109 |  |  | — |  |  | 109 |  |  | — |  |  | 2,183 |  |  | — |  |  | 2,183 |  |  | NM |  |
| Non-interest expense |  |  | 9,590 |  |  | 9,928 |  |  | (338) |  |  | (3.4) |  |  | 29,149 |  |  | 30,138 |  |  | (989) |  |  | (3.3) |  |
| **Income before income taxes** |  |  | 4,814 |  |  | 3,544 |  |  | 1,270 |  |  | 35.8 |  |  | 14,928 |  |  | 9,178 |  |  | 5,750 |  |  | 62.6 |  |
| Income tax expense |  |  | 954 |  |  | 446 |  |  | 508 |  |  | 113.9 |  |  | 2,882 |  |  | 1,083 |  |  | 1,799 |  |  | 166.1 |  |
| **Net income** |  | $ | 3,860 |  | $ | 3,098 |  | $ | 762 |  |  | 24.6 | % | $ | 12,046 |  | $ | 8,095 |  | $ | 3,951 |  |  | 48.8 | % |

***Consolidated net income*** of $3.9 million, or $0.62 per diluted share, for the three months ended September 30, 2019 increased $762,000 compared to $3.1 million, or $0.49 per diluted share, for the three months ended September 30, 2018. For the three months ended September 30, 2019, the return on average assets was 1.07%, the return on average stockholders’ equity was 13.72%, and the efficiency ratio was 64.86%.

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Consolidated net income of $12.0 million, or $1.92 per diluted share, for the nine months ended September 30, 2019 increased $3.9 million compared to $8.1 million, or $1.29 per diluted share, for the nine months ended September 30, 2018. For the nine months ended September 30, 2019, the return on average assets was 1.09%, the return on average stockholders’ equity was 15.03%, and the efficiency ratio was 68.13%.

***Net interest income*** was $12.4 million and $36.1 million for the three and nine months ended September 30, 2019, respectively, compared to $11.3 million and $33.1 million for the three and nine months ended September 30, 2018, respectively.  The net interest margin (expressed on a fully taxable equivalent basis) increased to 3.64% for the three months ended September 30, 2019, compared to 3.31% for the three months ended September 30, 2018, and increased to 3.47% for the nine months ended September 30, 2019 compared to 3.29% for the nine months ended September 30, 2018. These changes are discussed in greater detail under the *Average Balance Sheets and Rate and Volume Analysis* section below.

A $450,000 and $850,000 ***provision for loan losses*** was recorded for the three and nine months ended September 30, 2019, respectively, compared to a $250,000 and $1 million provision for the three and nine months ended September 30, 2018, respectively.

The Company’s net loan charge-offs were $155,000, or 0.01% of average loans, and $324,000, or 0.03% of average loans, for the three and nine months ended September 30, 2019, respectively, compared to net charge-offs of $104,000, or 0.01% of average loans, and $494,000, or 0.05%  of average loans, for the three and nine months ended September 30, 2018, respectively.

Non-performing loans totaled $4.8 million, or 0.41% of total loans, at September 30, 2019 compared to $5.6 million, or 0.49% of total loans, at December 31, 2018, and $6.3 million, or 0.56% of total loans, at September 30, 2018. These changes are discussed in greater detail under the *Lending and Credit Management* section below.

***Non-interest income*** increased $60,000, or 2.5%, for the three months ended September 30, 2019 compared to the three months ended September 30, 2018, and decreased $333,000, or 4.8%, for the nine months ended September 30, 2019 compared to the nine months ended September 30, 2018. These changes are discussed in greater detail under the *Non-interest Income and Expense* section below.

***Investment securities (losses) gains, net*** of $(40,000) were recorded for both the three and nine months ended September 30, 2019, respectively, compared to $50,000 and $256,000 for the three and nine months ended September 30, 2018, respectively. Securities gains for both the three and nine months ended September 30, 2018 included gains realized from a series of short-term sales of U.S. Treasury securities with repurchase agreements in order to generate capital gains to offset capital losses expiring in 2018 and 2019.

***Gain on branch sale, net***On February 8, 2019, Hawthorn Bank, a wholly-owned subsidiary of Hawthorn Bancshares, Inc., completed the sale of its branch located in Branson, Missouri to Branson Bank, Branson, Missouri. The Company sold the land and building for $3.5 million with a net book value of $1.7 million and transferred approximately $10.6 million in deposits, subject to future adjustments required in the definitive agreement for a deposit premium of 4.1%, or $0.3 million, excluding future contingent adjustments. The sale resulted in a pre-tax gain of approximately $2.2 million, or $1.7 million after tax for the nine months ended September 30, 2019. Included in the current quarter's net income the final pretax gain on the sale of our Branson branch of $0.1 million, or $0.1 million after tax, was recognized resulting from contingent deposit accounts.

***Non-interest expense*** decreased  $338,000, or 3.4%, for the three months ended September 30, 2019 compared to the three months ended September 30, 2018, and decreased $989,000, or 3.3%, for the nine months ended September 30, 2019 compared to the nine months ended September 30, 2018. These changes are discussed in greater detail under the *Non-interest Income and Expense* section below.

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***Average Balance Sheets***

***Net interest income*** is the largest source of revenue resulting from the Company’s lending, investing, borrowing, and deposit gathering activities. It is affected by both changes in the level of interest rates and changes in the amounts and mix of interest earning assets and interest bearing liabilities. The following table presents average balance sheets, net interest income, average yields of earning assets, average costs of interest bearing liabilities, net interest spread and net interest margin on a fully taxable equivalent basis for each of the periods ended September 30, 2019 and 2018, respectively.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | | | | | | | | | | | |  |
|  |  | **2019** | | | | | | |  | **2018** | | | | | | |  |
|  |  |  |  |  | **Interest** | |  | **Rate** |  |  |  |  | **Interest** | |  | **Rate** |  |
|  |  | **Average** | |  | **Income/** | |  | **Earned/** |  | **Average** | |  | **Income/** | |  | **Earned/** |  |
| *(In thousands)* |  | **Balance** | |  | **Expense(1)** | |  | **Paid(1)** |  | **Balance** | |  | **Expense(1)** | |  | **Paid(1)** |  |
| **ASSETS** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Loans: (2) (4)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial |  | $ | 198,444 |  | $ | 2,777 |  | 5.55 | % | $ | 199,911 |  | $ | 2,556 |  | 5.07 | % |
| Real estate construction - residential |  |  | 24,895 |  |  | 369 |  | 5.88 |  |  | 29,444 |  |  | 404 |  | 5.44 |  |
| Real estate construction - commercial |  |  | 122,179 |  |  | 1,614 |  | 5.24 |  |  | 108,916 |  |  | 1,368 |  | 4.98 |  |
| Real estate mortgage - residential |  |  | 248,210 |  |  | 3,229 |  | 5.16 |  |  | 246,568 |  |  | 3,020 |  | 4.86 |  |
| Real estate mortgage - commercial |  |  | 527,324 |  |  | 6,538 |  | 4.92 |  |  | 482,800 |  |  | 5,662 |  | 4.65 |  |
| Installment and other consumer |  |  | 31,649 |  |  | 354 |  | 4.44 |  |  | 33,494 |  |  | 331 |  | 3.92 |  |
| **Total loans** |  | $ | 1,152,701 |  | $ | 14,881 |  | 5.12 | % | $ | 1,101,133 |  | $ | 13,341 |  | 4.81 | % |
| **Investment securities: (3)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 1,340 |  | $ | 7 |  | 2.07 | % | $ | 11,119 |  | $ | 66 |  | 2.36 | % |
| U.S. government and federal agency obligations |  |  | 33,249 |  |  | 150 |  | 1.79 |  |  | 57,080 |  |  | 259 |  | 1.80 |  |
| Obligations of states and political subdivisions |  |  | 30,129 |  |  | 219 |  | 2.88 |  |  | 40,957 |  |  | 267 |  | 2.59 |  |
| Mortgage-backed securities |  |  | 119,911 |  |  | 595 |  | 1.97 |  |  | 125,976 |  |  | 683 |  | 2.15 |  |
| Other debt securities |  |  | 4,415 |  |  | 63 |  | 5.66 |  |  | 4,485 |  |  | 63 |  | 5.57 |  |
| **Total investment securities** |  | $ | 189,044 |  | $ | 1,034 |  | 2.17 | % | $ | 239,617 |  | $ | 1,338 |  | 2.22 | % |
| Other investment securities |  |  | 5,968 |  |  | 66 |  | 4.39 |  |  | 4,737 |  |  | 59 |  | 4.94 |  |
| Federal funds sold and interest bearing deposits in other financial institutions |  |  | 16,375 |  |  | 103 |  | 2.50 |  |  | 32,831 |  |  | 205 |  | 2.48 |  |
| **Total interest earning assets** |  | $ | 1,364,088 |  | $ | 16,084 |  | 4.68 | % | $ | 1,378,318 |  | $ | 14,943 |  | 4.30 | % |
| All other assets |  |  | 80,345 |  |  |  |  |  |  |  | 84,359 |  |  |  |  |  |  |
| Allowance for loan losses |  |  | (11,933) |  |  |  |  |  |  |  | (11,341) |  |  |  |  |  |  |
| **Total assets** |  | $ | 1,432,500 |  |  |  |  |  |  | $ | 1,451,336 |  |  |  |  |  |  |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| NOW accounts |  | $ | 165,275 |  | $ | 272 |  | 0.65 | % | $ | 204,370 |  | $ | 513 |  | 1.00 | % |
| Savings |  |  | 98,008 |  |  | 26 |  | 0.11 |  |  | 96,548 |  |  | 13 |  | 0.05 |  |
| Interest checking |  |  | 11,807 |  |  | 62 |  | 2.08 |  |  | 3,051 |  |  | 6 |  | 0.78 |  |
| Money market |  |  | 271,068 |  |  | 687 |  | 1.01 |  |  | 312,597 |  |  | 936 |  | 1.19 |  |
| Time deposits |  |  | 324,081 |  |  | 1,276 |  | 1.56 |  |  | 319,809 |  |  | 911 |  | 1.13 |  |
| **Total interest bearing deposits** |  | $ | 870,239 |  | $ | 2,323 |  | 1.06 | % | $ | 936,375 |  | $ | 2,379 |  | 1.01 | % |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 21,947 |  |  | 34 |  | 0.61 |  |  | 36,743 |  |  | 166 |  | 1.79 |  |
| Federal Home Loan Bank advances and other borrowings |  |  | 100,990 |  |  | 619 |  | 2.43 |  |  | 71,780 |  |  | 314 |  | 1.74 |  |
| Subordinated notes |  |  | 49,486 |  |  | 588 |  | 4.71 |  |  | 49,486 |  |  | 584 |  | 4.68 |  |
| **Total borrowings** |  | $ | 172,423 |  | $ | 1,241 |  | 2.86 | % | $ | 158,009 |  | $ | 1,064 |  | 2.67 | % |
| **Total interest bearing liabilities** |  | $ | 1,042,662 |  | $ | 3,564 |  | 1.36 | % | $ | 1,094,384 |  | $ | 3,443 |  | 1.25 | % |
| Demand deposits |  |  | 263,336 |  |  |  |  |  |  |  | 250,624 |  |  |  |  |  |  |
| Other liabilities |  |  | 14,879 |  |  |  |  |  |  |  | 11,944 |  |  |  |  |  |  |
| **Total liabilities** |  |  | 1,320,877 |  |  |  |  |  |  |  | 1,356,952 |  |  |  |  |  |  |
| Stockholders' equity |  |  | 111,623 |  |  |  |  |  |  |  | 94,384 |  |  |  |  |  |  |
| **Total liabilities and stockholders' equity** |  | $ | 1,432,500 |  |  |  |  |  |  | $ | 1,451,336 |  |  |  |  |  |  |
| **Net interest income (FTE)** |  |  |  |  | $ | 12,520 |  |  |  |  |  |  | $ | 11,500 |  |  |  |
| **Net interest spread** |  |  |  |  |  |  |  | 3.32 | % |  |  |  |  |  |  | 3.05 | % |
| **Net interest margin** |  |  |  |  |  |  |  | 3.64 | % |  |  |  |  |  |  | 3.31 | % |

(1)Interest income and yields are presented on a fully taxable equivalent basis using the federal statutory income tax rate of 21%, net of nondeductible interest expense, for the three months ended September 30, 2019 and 2018 respectively. Such adjustments totaled $159,000 and $192,000 for the three months ended September 30, 2019 and 2018, respectively.

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

(3)Average balances based on amortized cost.

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

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|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Nine Months Ended September 30,** | | | | | | | | | | | | | | |  |
|  |  | **2019** | | | | | | |  | **2018** | | | | | | |  |
|  |  |  |  |  | **Interest** | |  | **Rate** |  |  |  |  | **Interest** | |  | **Rate** |  |
|  |  | **Average** | |  | **Income/** | |  | **Earned/** |  | **Average** | |  | **Income/** | |  | **Earned/** |  |
| *(In thousands)* |  | **Balance** | |  | **Expense(1)** | |  | **Paid(1)** |  | **Balance** | |  | **Expense(1)** | |  | **Paid(1)** |  |
| **ASSETS** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Loans: (2) (4)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial |  | $ | 202,708 |  | $ | 8,408 |  | 5.55 | % | $ | 198,074 |  | $ | 7,362 |  | 4.97 | % |
| Real estate construction - residential |  |  | 26,623 |  |  | 1,195 |  | 6.00 |  |  | 29,208 |  |  | 1,135 |  | 5.20 |  |
| Real estate construction - commercial |  |  | 115,923 |  |  | 4,536 |  | 5.23 |  |  | 104,335 |  |  | 3,774 |  | 4.84 |  |
| Real estate mortgage - residential |  |  | 246,996 |  |  | 9,456 |  | 5.12 |  |  | 247,165 |  |  | 8,846 |  | 4.79 |  |
| Real estate mortgage - commercial |  |  | 528,152 |  |  | 19,263 |  | 4.88 |  |  | 476,724 |  |  | 16,546 |  | 4.64 |  |
| Installment and other consumer |  |  | 31,895 |  |  | 1,035 |  | 4.34 |  |  | 32,838 |  |  | 938 |  | 3.82 |  |
| **Total loans** |  | $ | 1,152,297 |  | $ | 43,893 |  | 5.09 | % | $ | 1,088,344 |  | $ | 38,601 |  | 4.74 | % |
| **Investment securities: (3)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 2,160 |  | $ | 35 |  | 2.17 | % | $ | 16,857 |  | $ | 205 |  | 1.63 | % |
| U.S. government and federal agency obligations |  |  | 43,982 |  |  | 621 |  | 1.89 |  |  | 53,600 |  |  | 690 |  | 1.72 |  |
| Obligations of states and political subdivisions |  |  | 35,876 |  |  | 743 |  | 2.77 |  |  | 42,347 |  |  | 858 |  | 2.71 |  |
| Mortgage-backed securities |  |  | 120,698 |  |  | 1,961 |  | 2.17 |  |  | 126,092 |  |  | 2,009 |  | 2.13 |  |
| Other debt securities |  |  | 4,389 |  |  | 190 |  | 5.79 |  |  | 4,485 |  |  | 184 |  | 5.49 |  |
| **Total investment securities** |  | $ | 207,105 |  | $ | 3,550 |  | 2.29 | % | $ | 243,381 |  | $ | 3,946 |  | 2.17 | % |
| Other investment securities |  |  | 5,709 |  |  | 199 |  | 4.66 |  |  | 5,042 |  |  | 162 |  | 4.30 |  |
| Federal funds sold and interest bearing deposits in other financial institutions |  |  | 47,724 |  |  | 897 |  | 2.51 |  |  | 32,416 |  |  | 500 |  | 2.06 |  |
| **Total interest earning assets** |  | $ | 1,412,835 |  | $ | 48,539 |  | 4.59 | % | $ | 1,369,183 |  | $ | 43,209 |  | 4.22 | % |
| All other assets |  |  | 82,791 |  |  |  |  |  |  |  | 84,485 |  |  |  |  |  |  |
| Allowance for loan losses |  |  | (11,874) |  |  |  |  |  |  |  | (11,121) |  |  |  |  |  |  |
| **Total assets** |  | $ | 1,483,752 |  |  |  |  |  |  | $ | 1,442,547 |  |  |  |  |  |  |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| NOW accounts |  | $ | 208,639 |  | $ | 1,708 |  | 1.09 | % | $ | 225,376 |  | $ | 1,605 |  | 0.95 | % |
| Savings |  |  | 95,792 |  |  | 65 |  | 0.09 |  |  | 96,024 |  |  | 36 |  | 0.05 |  |
| Interest checking |  |  | 11,572 |  |  | 170 |  | 1.96 |  |  | 2,855 |  |  | 16 |  | 0.75 |  |
| Money market |  |  | 280,643 |  |  | 2,273 |  | 1.08 |  |  | 290,374 |  |  | 2,242 |  | 1.03 |  |
| Time deposits |  |  | 341,466 |  |  | 4,030 |  | 1.58 |  |  | 308,243 |  |  | 2,391 |  | 1.04 |  |
| **Total interest bearing deposits** |  | $ | 938,112 |  | $ | 8,246 |  | 1.18 | % | $ | 922,872 |  | $ | 6,290 |  | 0.91 | % |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 21,716 |  |  | 110 |  | 0.68 |  |  | 43,101 |  |  | 526 |  | 1.63 |  |
| Federal Home Loan Bank advances and other borrowings |  |  | 94,969 |  |  | 1,699 |  | 2.39 |  |  | 80,745 |  |  | 1,042 |  | 1.73 |  |
| Subordinated notes |  |  | 49,486 |  |  | 1,821 |  | 4.92 |  |  | 49,486 |  |  | 1,635 |  | 4.42 |  |
| **Total borrowings** |  | $ | 166,171 |  | $ | 3,630 |  | 2.92 | % | $ | 173,332 |  | $ | 3,203 |  | 2.47 | % |
| **Total interest bearing liabilities** |  | $ | 1,104,283 |  | $ | 11,876 |  | 1.44 | % | $ | 1,096,204 |  | $ | 9,493 |  | 1.16 | % |
| Demand deposits |  |  | 257,157 |  |  |  |  |  |  |  | 241,618 |  |  |  |  |  |  |
| Other liabilities |  |  | 15,143 |  |  |  |  |  |  |  | 12,179 |  |  |  |  |  |  |
| **Total liabilities** |  |  | 1,376,583 |  |  |  |  |  |  |  | 1,350,001 |  |  |  |  |  |  |
| Stockholders' equity |  |  | 107,169 |  |  |  |  |  |  |  | 92,546 |  |  |  |  |  |  |
| **Total liabilities and stockholders' equity** |  | $ | 1,483,752 |  |  |  |  |  |  | $ | 1,442,547 |  |  |  |  |  |  |
| **Net interest income (FTE)** |  |  |  |  | $ | 36,663 |  |  |  |  |  |  | $ | 33,716 |  |  |  |
| **Net interest spread** |  |  |  |  |  |  |  | 3.15 | % |  |  |  |  |  |  | 3.06 | % |
| **Net interest margin** |  |  |  |  |  |  |  | 3.47 | % |  |  |  |  |  |  | 3.29 | % |

(1)Interest income and yields are presented on a fully taxable equivalent basis using the federal statutory income tax rate of 21%, net of nondeductible interest expense, for the nine months ended September 30, 2019 and 2018, respectively. Such adjustments totaled $516,000 and $626,000 for the nine months ended September 30, 2019 and 2018, respectively.

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

(3)Average balances based on amortized cost.

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

***Rate and Volume Analysis***

The following table summarizes the changes in net interest income on a fully taxable equivalent basis, by major category of interest earning assets and interest bearing liabilities, identifying changes related to volumes and rates for the three and nine months ended September 30, 2019 compared to the three and nine months ended September 30, 2018. The change in

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interest due to the combined rate/volume variance has been allocated to rate and volume changes in proportion to the absolute dollar amounts of change in each.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | | | | |  | **Nine Months Ended September 30,** | | | | | | | |  |
|  |  | **2019 vs. 2018** | | | | | | | |  | **2019 vs. 2018** | | | | | | | |  |
|  |  |  |  |  | **Change due to** | | | | |  |  |  |  | **Change due to** | | | | |  |
|  |  | **Total** | |  | **Average** | |  | **Average** | |  | **Total** | |  | **Average** | |  | **Average** | |  |
| *(In thousands)* |  | **Change** | |  | **Volume** | |  | **Rate** | |  | **Change** | |  | **Volume** | |  | **Rate** | |  |
| **Interest income on a fully taxable equivalent basis: (1)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Loans: (2) (4)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial |  | $ | 221 |  | $ | (19) |  | $ | 240 |  | $ | 1,046 |  | $ | 175 |  | $ | 871 |  |
| Real estate construction - residential |  |  | (35) |  |  | (65) |  |  | 30 |  |  | 60 |  |  | (106) |  |  | 166 |  |
| Real estate construction - commercial |  |  | 246 |  |  | 173 |  |  | 73 |  |  | 762 |  |  | 439 |  |  | 323 |  |
| Real estate mortgage - residential |  |  | 209 |  |  | 20 |  |  | 189 |  |  | 610 |  |  | (6) |  |  | 616 |  |
| Real estate mortgage - commercial |  |  | 876 |  |  | 540 |  |  | 336 |  |  | 2,717 |  |  | 1,847 |  |  | 870 |  |
| Installment and other consumer |  |  | 23 |  |  | (19) |  |  | 42 |  |  | 97 |  |  | (28) |  |  | 125 |  |
| **Investment securities: (3)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  |  | (59) |  |  | (52) |  |  | (7) |  |  | (170) |  |  | (222) |  |  | 52 |  |
| U.S. government and federal agency obligations |  |  | (109) |  |  | (107) |  |  | (2) |  |  | (69) |  |  | (132) |  |  | 63 |  |
| Obligations of states and political subdivisions |  |  | (48) |  |  | (77) |  |  | 29 |  |  | (115) |  |  | (134) |  |  | 19 |  |
| Mortgage-backed securities |  |  | (88) |  |  | (32) |  |  | (56) |  |  | (48) |  |  | (87) |  |  | 39 |  |
| Other debt securities |  |  | — |  |  | (1) |  |  | 1 |  |  | 6 |  |  | (4) |  |  | 10 |  |
| Other investment securities |  |  | 7 |  |  | 14 |  |  | (7) |  |  | 37 |  |  | 22 |  |  | 15 |  |
| Federal funds sold and interest bearing deposits in other financial institutions |  |  | (102) |  |  | (104) |  |  | 2 |  |  | 397 |  |  | 271 |  |  | 126 |  |
| **Total interest income** |  |  | 1,141 |  |  | 271 |  |  | 870 |  |  | 5,330 |  |  | 2,035 |  |  | 3,295 |  |
| **Interest expense:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| NOW accounts |  |  | (241) |  |  | (86) |  |  | (155) |  |  | 103 |  |  | (125) |  |  | 228 |  |
| Savings |  |  | 13 |  |  | — |  |  | 13 |  |  | 29 |  |  | — |  |  | 29 |  |
| Interest checking |  |  | 56 |  |  | 35 |  |  | 21 |  |  | 154 |  |  | 101 |  |  | 53 |  |
| Money market |  |  | (249) |  |  | (115) |  |  | (134) |  |  | 31 |  |  | (76) |  |  | 107 |  |
| Time deposits |  |  | 365 |  |  | 12 |  |  | 353 |  |  | 1,639 |  |  | 281 |  |  | 1,358 |  |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | (132) |  |  | (50) |  |  | (82) |  |  | (416) |  |  | (191) |  |  | (225) |  |
| Federal Home Loan Bank advances and other borrowings |  |  | 305 |  |  | 154 |  |  | 151 |  |  | 657 |  |  | 206 |  |  | 451 |  |
| Subordinated notes |  |  | 4 |  |  | — |  |  | 4 |  |  | 186 |  |  | — |  |  | 186 |  |
| **Total interest expense** |  |  | 121 |  |  | (50) |  |  | 171 |  |  | 2,383 |  |  | 196 |  |  | 2,187 |  |
| **Net interest income on a fully taxable equivalent basis** |  | $ | 1,020 |  | $ | 321 |  | $ | 699 |  | $ | 2,947 |  | $ | 1,839 |  | $ | 1,108 |  |

(1)Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 21%, net of nondeductible interest expense, for the three months ended September 30, 2019 and 2018, respectively. Such adjustments totaled $159,000 and $516,000 for the three and nine months ended September 30, 2019, respectively, compared to $192,000 and $626,000 for the three and nine months ended September 30, 2018, respectively.

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

(3)Average balances based on amortized cost.

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

Financial results for the quarter ended September 30, 2019 compared to the quarter ended September 30, 2018, reflected an increase in net interest income, on a tax equivalent basis, of $1.0 million, or 8.87%, and financial results for the nine months ended September 30, 2019 compared to the nine months ended September 30, 2018 reflected an increase in net interest income of $2.9 million, or 8.74%. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) increased to 3.64% for the quarter ended September 30, 2019, compared to 3.31% for the quarter ended September 30, 2018, and increased to 3.47% for the nine months ended September 30, 2019 compared to 3.29% for the nine months ended September 30, 2018. Net interest income and net interest margin increased primarily due to an increase in average balances and rates earned on loans in the three and nine month comparative periods.

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Average interest-earning assets decreased $14.2 million, or 1.03%, to $1.36 billion for the three months ended September 30, 2019 compared to $1.38 billion for the three months ended September 30, 2018, and average interest bearing liabilities decreased $51.7 million, or 4.73%, to $1.04 billion for the three months ended September 30, 2019 compared to $1.09 billion for the three months ended September 30, 2018.

Average interest-earning assets increased $43.7 million, or 3.19%, to $1.41 billion for the nine months ended September 30, 2019 compared to $1.37 billion for the nine months ended September 30, 2018, and average interest bearing liabilities increased $8.1 million, or 0.74%, to $1.10 billion for the nine months ended September 30, 2019 compared to $1.10 billion for the nine months ended September 30, 2018.

***Total interest income*** (expressed on a fully taxable equivalent basis) was $16.1 million and $48.5 million for the three and nine months ended September 30, 2019, respectively, compared to $14.9 million and $43.2 million for the three and nine months ended September 30, 2018, respectively. The Company’s rates earned on interest earning assets were 4.68%  and 4.59%  for the three and nine months ended September 30, 2019, respectively, compared to 4.30%  and 4.22%  for the three and nine months ended September 30, 2018, respectively.

***Interest income on loans*** increased to $14.9 million and $43.9 million for the three and nine months ended September 30, 2019, respectively, compared to $13.3 million and $38.6 million for the three and nine months ended September 30, 2018, respectively.

Average loans outstanding increased $51.6 million, or 4.68%, to $1.15 billion for the three months ended September 30, 2019 compared to $1.10 billion for the three months ended September 30, 2018. The average yield on loans increased to 5.12% for the three months ended September 30, 2019 compared to 4.81% for the three months ended September 30, 2018.

Average loans outstanding increased $64.0 million, or 5.88%, to $1.15 billion for the nine months ended September 30, 2019 compared to $1.09 billion for the nine months ended September 30, 2018. The average yield on loans increased to 5.09% for the nine months ended September 30, 2019 compared to 4.74% for the nine months ended September 30, 2018. See the *Lending and Credit Management* section for further discussion of changes in the composition of the lending portfolio.

***Total interest expense*** increased to $3.6 million and $11.9 million for the three and nine months ended September 30, 2019, respectively, compared to $3.4 million and $9.5 million for the three and nine months ended September 30, 2018, respectively. The Company’s rates paid on interest bearing liabilities were 1.36% and 1.44% for the three and nine months ended September 30, 2019, respectively, compared to 1.25%  and 1.16%  for the three and nine months ended September 30, 2018, respectively. See the *Liquidity Management* section for further discussion.

***Interest expense on deposits*** increased to $2.3 million and $8.2 million for the three and nine months ended September 30, 2019, respectively, compared to $2.4 million and $6.3 million for the three and nine months ended September 30, 2018, respectively.

Average interest bearing deposits decreased $66.1 million, or 7.06%, to $870.2 million for the three months ended September 30, 2019 compared to $936.4 million for the three months ended September 30, 2018.  These decreases were primarily due to a  decrease in public funds resulting from the loss of a public fund account at renewal,  and decreases in NOW accounts, and money market accounts due to lower market rates paid during the current quarter. The average cost of deposits increased to 1.06% for the three months ended September 30, 2019 compared to 1.01% for the three months ended September 30, 2018. The increase was primarily due to generally higher market interest rates quarter over quarter.

Average interest bearing deposits increased $15.2 million, or 1.7%, to $938.1 million for the nine months ended September 30, 2019 compared to $922.9 million for the nine months ended September 30, 2018. These increases were primarily due to increases in brokered deposits. The average cost of deposits increased to 1.18% for the nine months ended September 30, 2019 compared to 0.91% for the nine months ended September 30, 2018.  The increase was primarily due to generally higher market interest rates year over year.

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***Interest expense on borrowings*** increased to $1.2 million and $3.6 million for the three and nine months ended September 30, 2019, respectively, compared to $1.1 million and $3.2 million for the three and nine months ended September 30, 2018, respectively.

Average borrowings increased to $172.4 million for the three months ended September 30, 2019 compared to $158.0 million for the three months ended September 30, 2018.  The increase in average borrowings was primarily due to an increase in FHLB advances to fund liquidity needs. The average cost of borrowings increased to 2.86% for the three months ended September 30, 2019 compared to 2.67% for the three months ended September 30, 2018. The increase in cost of funds primarily resulted from higher market interest rates.

Average borrowings decreased to $166.2 million for the nine months ended September 30, 2019 compared to $173.3 million for the nine months ended September 30, 2018. The decrease in average borrowings was primarily due to the $21.4 million decrease in average repurchase agreements due to a tax initiative involving short sales of a U.S. Treasury security funded by a repurchase agreement during the nine months ended September 30, 2018.  The increase was partially offset by an increase in FHLB advances to fund liquidity needs during 2019. The average cost of borrowings increased to 2.92% for the  nine months ended September 30, 2019 compared to 2.47% for the nine months ended September 30, 2018.  The increase in cost of funds primarily resulted from higher market interest rates.  See the *Liquidity Management* section for further discussion.

***Non-interest income and expense***

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | | | | | | | |  | **Nine Months Ended September 30,** | | | | | | | | | | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  | **$ Change** | |  | **% Change** | |  | **2019** | |  | **2018** | |  | **$ Change** | |  | **% Change** | |  |
| **Non-interest income** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Service charges and other fees |  | $ | 953 |  | $ | 942 |  | $ | 11 |  |  | 1.2 | % | $ | 2,701 |  | $ | 2,760 |  | $ | (59) |  |  | (2.1) | % |
| Bank card income and fees |  |  | 794 |  |  | 699 |  |  | 95 |  |  | 13.6 |  |  | 2,282 |  |  | 2,064 |  |  | 218 |  |  | 10.6 |  |
| Trust department income |  |  | 371 |  |  | 276 |  |  | 95 |  |  | 34.4 |  |  | 960 |  |  | 867 |  |  | 93 |  |  | 10.7 |  |
| Real estate servicing fees, net |  |  | 36 |  |  | 192 |  |  | (156) |  |  | (81.3) |  |  | 38 |  |  | 574 |  |  | (536) |  |  | (93.4) |  |
| Gain on sales of mortgage loans, net |  |  | 215 |  |  | 205 |  |  | 10 |  |  | 4.9 |  |  | 499 |  |  | 592 |  |  | (93) |  |  | (15.7) |  |
| Other |  |  | 55 |  |  | 50 |  |  | 5 |  |  | 10.0 |  |  | 157 |  |  | 113 |  |  | 44 |  |  | 38.9 |  |
| **Total non-interest income** |  | $ | 2,424 |  | $ | 2,364 |  | $ | 60 |  |  | 2.5 | % | $ | 6,637 |  | $ | 6,970 |  | $ | (333) |  |  | (4.8) | % |
| Non-interest income as a % of total revenue \* |  |  | 16.4 | % |  | 17.3 | % |  |  |  |  |  |  |  | 15.5 | % |  | 17.4 | % |  |  |  |  |  |  |

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

***Total non-interest income*** increased $60,000, or 2.5%, to $2.4 million for the quarter ended September 30, 2019 compared to $2.4 million for the quarter ended September 30, 2018, and decreased $333,000, or 4.8%, to $6.6 million for the nine months ended September 30, 2019 compared to $7.0 million for the nine months ended September 30, 2018.

***Bank card income and fees*** increased $95,000, or 13.6%, to $794,000 for the quarter ended September 30, 2019 compared to $699,000 for the quarter ended September 30, 2018, and increased $218,000, or 10.6%, to $2.3 million for the nine months ended September 30, 2109 compared to $2.1 million for the nine months ended September 30, 2018. The increase in both periods presented was primarily due to increases in volume in debit card, credit card, and merchant service income.

***Trust department income*** increased $95,000, or 34.4%, to $371,000 for the quarter ended September 30, 2019 compared to $276,000 for the quarter ended September 30, 2018, and increased $93,000, or 10.7%, to $960,000 for the nine months ended September 30, 2109 compared to $867,000 for the nine months ended September 30, 2018. The increase in both periods presented was primarily due to one-time fees received during the third quarter ended September 30, 2019.

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***Real estate servicing fees, net*** of the change in valuation of mortgage serving rights (MSRs) decreased $156,000 to $36,000 for the quarter ended September 30, 2019 compared to $192,000 for the quarter ended September 30, 2018, and decreased $536,000 to $38,000 for the nine months ended September 30, 2019 compared to $574,000 for the nine months ended September 30, 2018. The decreases in the periods presented were primarily due to decreases in fair value of the MSRs resulting from lower market interest rates that increased loan prepayments.

Mortgage loan servicing fees earned on loans sold were $205,000 and $581,000 for the three and nine months ended September 30, 2019, respectively, compared to $201,000 and $614,000 for the three and nine months ended September 30, 2018, respectively. The Company was servicing $270.8 million of mortgage loans at September 30, 2019 compared to $279.9 million and $282.9 million at December 31, 2018 and September 30, 2018, respectively.

***Gain on sales of mortgage loans*** increased $10,000, or 4.9%, to $215,000 for the quarter ended September 30, 2019 compared to $205,000 for the quarter ended September 30, 2018, and decreased $93,000, or 15.7%, to $499,000 for the nine months ended September 30, 2019 compared to $592,000 for the nine months ended September 30, 2018.  The increase for the quarter ended September 30, 2019 over the quarter ended September 30, 2018 was primarily due to an increase in refinancing activity during the current quarter due to the decrease in market interest rates. The decrease in the nine months ended September 30, 2019 over the nine months ended September 30, 2018  was primarily due to lower loan origination volume in comparative periods. The Company sold $13.3 million of loans for the three months ended September 30, 2019 compared to $10.3 million for the three months ended September 30, 2018, and $28.3 million for the nine months ended September 30, 2019 compared to $30.0 million for the nine months ended September 30, 2018.

***Other Income*** increased $5,000, or 10.0%, to $55,000 for the quarter ended September 30, 2019 compared to $50,000 for the quarter ended September 30, 2018, and increased $44,000, or 38.9%, to $157,000 for the nine months ended September 30, 2109 compared to $113,000 for the nine months ended September 30, 2018. The increase in both periods presented was primarily due to increases in insurance commissions and rental income received on a  bank owned building in other real estate owned.

**Investment securities (losses) gains, net for the periods indicated were as follows:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | |  | **Nine Months Ended September 30,** | | | | |  |
| *(in thousands)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| ***Investment securities (losses) gains, net*** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Available for sale securities:** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Gains realized on sales |  | $ | 6 |  | $ | 47 |  | $ | 6 |  | $ | 253 |  |
| Losses realized on sales |  |  | (46) |  |  | — |  |  | (46) |  |  | — |  |
| Other-than-temporary impairment recognized |  |  | — |  |  | — |  |  | — |  |  | — |  |
| **Other investment securities:** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Fair value adjustments, net |  |  | — |  |  | 3 |  |  | — |  |  | 3 |  |
| **Investment securities (losses) gains, net** |  | **$** | **(40)** |  | **$** | **50** |  | **$** | **(40)** |  | **$** | **256** |  |

During the three and nine months ended September 30, 2019, the Company received $21.5 million of proceeds from the sale of available for sale debt securities. During the three and nine months ended September 30, 2018, the Company received $25.4 million and $77.2 million, respectively, of proceeds from a series of short-term sales of U.S. Treasury securities purchased with repurchase agreements, and recognized gains of $47,000 and $253,000, respectively, in order to generate capital gains to offset capital losses that were to expire during 2018 and 2019.

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**Gain on branch sale, net**

On February 8, 2019, Hawthorn Bank, a wholly-owned subsidiary of Hawthorn Bancshares, Inc., completed the sale of its branch located in Branson, Missouri to Branson Bank, Branson, Missouri. The Company sold the land and building for $3.5 million with a net book value of $1.7 million and transferred approximately $10.6 million in deposits, subject to future adjustments required in the definitive agreement for a deposit premium of 4.1%, or $0.3 million, excluding future contingent adjustments. The sale resulted in a pre-tax gain of $0.1 million and $0.1 million after tax for the three months ended September 30, 2019 and $2.2 million and $1.7 million after tax for the nine months ended September 30, 2019.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended September 30,** | | | | | | | | | |  |  | **Nine Months Ended September 30,** | | | | | | | | | |  |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  | **$ Change** | |  | **% Change** |  |  | **2019** | |  | **2018** | |  | **$ Change** | |  | **% Change** |  |  |
| **Non-interest expense** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Salaries |  | $ | 3,956 |  | $ | 4,049 |  | $ | (93) |  | (2.3) | % |  | $ | 11,948 |  | $ | 12,849 |  | $ | (901) |  | (7.0) | % |  |
| Employee benefits |  |  | 1,410 |  |  | 1,494 |  |  | (84) |  | (5.6) |  |  |  | 4,272 |  |  | 4,564 |  |  | (292) |  | (6.4) |  |  |
| Occupancy expense, net |  |  | 909 |  |  | 749 |  |  | 160 |  | 21.4 |  |  |  | 2,348 |  |  | 2,162 |  |  | 186 |  | 8.6 |  |  |
| Furniture and equipment expense |  |  | 671 |  |  | 785 |  |  | (114) |  | (14.5) |  |  |  | 2,166 |  |  | 2,104 |  |  | 62 |  | 2.9 |  |  |
| Processing, network and bank card expense |  |  | 893 |  |  | 841 |  |  | 52 |  | 6.2 |  |  |  | 2,867 |  |  | 2,589 |  |  | 278 |  | 10.7 |  |  |
| Legal, examination, and professional fees |  |  | 316 |  |  | 289 |  |  | 27 |  | 9.3 |  |  |  | 948 |  |  | 913 |  |  | 35 |  | 3.8 |  |  |
| Advertising and promotion |  |  | 343 |  |  | 297 |  |  | 46 |  | 15.5 |  |  |  | 884 |  |  | 840 |  |  | 44 |  | 5.2 |  |  |
| Postage, printing, and supplies |  |  | 181 |  |  | 256 |  |  | (75) |  | (29.3) |  |  |  | 650 |  |  | 749 |  |  | (99) |  | (13.2) |  |  |
| Other |  |  | 911 |  |  | 1,168 |  |  | (257) |  | (22.0) |  |  |  | 3,066 |  |  | 3,368 |  |  | (302) |  | (9.0) |  |  |
| **Total non-interest expense** |  | $ | 9,590 |  | $ | 9,928 |  | $ | (338) |  | (3.4) | % |  | $ | 29,149 |  | $ | 30,138 |  | $ | (989) |  | (3.3) | % |  |
| Efficiency ratio\* |  |  | 64.9 | % |  | 72.6 | % |  |  |  |  |  |  |  | 68.1 | % |  | 75.2 | % |  |  |  |  |  |  |
| Number of full-time equivalent employees |  |  |  |  |  |  |  |  |  |  |  |  |  |  | 277 |  |  | 299 |  |  |  |  |  |  |  |

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

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

***Total non-interest expense*** decreased $338,000, or 3.4%, to $9.6 million for the quarter ended September 30, 2019 compared to $9.9 million for the quarter ended September 30, 2018, and decreased $989,000, or 3.3%, to $29.1 million for the nine months ended September 30, 2019 compared to $30.1 million for the nine months ended September 30, 2018.

***Salaries*** decreased $93,000, or 2.3%, to $4.0 million for the quarter ended September 30, 2019 compared to $4.0 million for the quarter ended September 30, 2018, and decreased $901,000, or 7.0%, to $11.9 million for the nine months ended September 30, 2019 compared to $12.8 million for the nine months ended September 30, 2018.  The decrease in all periods presented was primarily due to a reduction of 22 full-time equivalent employees. In addition, a bonus was paid in February 2018 to all eligible full-time and part-time employees resulting from the expected tax savings from the Tax Act.

***Employee benefits*** decreased $84,000, or 5.6%, to $1.4 million for the quarter ended September 30, 2019 compared to $1.5 million for the quarter ended September 30, 2018, and decreased $292,000, or 6.4%, to $4.3 million for the nine months ended September 30, 2019 compared to $4.6 million for the nine months ended September 30, 2018. The decrease in all periods presented was primarily due to a decrease in medical plan premiums due to a reduction of employees as mentioned above, and a decrease in pension expense. The decreases were partially offset by an increase in the employer 401(k) and profit-sharing contributions.

***Occupancy expense*** increased $160,000, or 21.4%, to $909,000 for the quarter ended September 30, 2019 compared to $749,000 for the quarter ended September 30, 2018, and increased $186,000, or 8.6%, to $2.3 million for the nine months

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ended September 30, 2019 compared to $2.2 million for the nine months ended September 30, 2018.  The increase for all periods presented was primarily due to an increase in building and parking lot repairs and maintenance and building lease expense primarily related to the Company's new Columbia branch location. These increases were partially offset by a decrease in depreciation, utilities, and other occupancy expense due to the reduction of three branch locations since 2018.

***Furniture and equipment expense*** decreased $114,000, or 14.5%, to $671,000 for the quarter ended September 30, 2019 compared to $749,000 for the quarter ended September 30, 2018, and increased $62,000, or 2.9%, to $2.2 million for the nine months ended September 30, 2019 compared to $2.1 million for the nine months ended September 30, 2018. The decrease for the quarter ended September 30, 2019 over the quarter ended September 30, 2018 was primarily due to the timing of payments for reoccurring core maintenance agreements in the third quarter of 2018. The increase for the nine months ended September 30, 2019 over the nine months ended September 30, 2018 was primarily due to an increase in the monthly cost to maintain the Company's hosted network, and the replacement of several computers below the Company's capitalization threshold.

***Processing, network, and bank card expense*** increased $52,000, or 6.2%, to $893,000 for the quarter ended September 30, 2019 compared to $841,000 for the quarter ended September 30, 2018, and increased $278,000, or 10.7%, to $2.9 million for the nine months ended September 30, 2019 compared to $2.6 million for the nine months ended September 30, 2018.  The increases in all periods presented were primarily due to an increase in debit and credit card processing expenses.

***Other non-interest expense*** decreased $257,000, or 22.0%, to $911,000 for the quarter ended September 30, 2019 compared to $1.2 million for the quarter ended September 30, 2018, and decreased $302,000, or 9.0%, to $3.1 million for the nine months ended September 30, 2019 compared to $3.4 million for the nine months ended September 30, 2018. The decreases in all periods presented were primarily related to a FDIC assessment credit received in the third quarter of 2019 and improvements made during 2018 to a  former branch location to be listed for sale and is currently being rented. These decreases were partially offset by increases in software expense.

***Income taxes***

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 19.8% and 19.3% for the three and nine months ended September 30, 2019, respectively, compared to 12.6% and 11.8% for the three and nine months ended September 30, 2018, respectively.

The change in the effective tax rate for both the three and nine months ended September 30, 2019 over the three and nine months ended September 30, 2018, was primarily due to the final impacts of the Tax Cuts and Jobs Act which decreased the 2018 tax rate. In addition, the 2019 tax rate increased due to additional taxable income, which included a $2.2 million pre-tax gain from the sale of the Branson branch. Without the impact of these items, the year-to-date 2018 and 2019 tax rates would have been approximately 17.0% and 18.8%, respectively. The Company expects the effective tax rate to range between 18.5% and 19.5% going forward as the mix between taxable and tax-exempt income shifts.

**Lending and Credit Management**

Interest earned on the loan portfolio is a primary source of interest income for the Company. Net loans represented 78.6% of total assets as of September 30, 2019 compared to 76.6% as of December 31, 2018.

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

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  |
| Commercial, financial, and agricultural |  | $ | 193,267 |  | $ | 207,720 |  |
| Real estate construction - residential |  |  | 23,782 |  |  | 28,610 |  |
| Real estate construction - commercial |  |  | 124,389 |  |  | 106,784 |  |
| Real estate mortgage - residential |  |  | 248,435 |  |  | 241,517 |  |
| Real estate mortgage - commercial |  |  | 530,010 |  |  | 529,536 |  |
| Installment and other consumer |  |  | 31,635 |  |  | 32,460 |  |
| **Total loans** |  | $ | 1,151,518 |  | $ | 1,146,627 |  |
| **Percent of categories to total loans:** |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  |  | 16.8 | % |  | 18.1 | % |
| Real estate construction - residential |  |  | 2.1 |  |  | 2.5 |  |
| Real estate construction - commercial |  |  | 10.8 |  |  | 9.3 |  |
| Real estate mortgage - residential |  |  | 21.6 |  |  | 21.1 |  |
| Real estate mortgage - commercial |  |  | 46.0 |  |  | 46.2 |  |
| Installment and other consumer |  |  | 2.7 |  |  | 2.8 |  |
| **Total** |  |  | 100.0 | % |  | 100.0 | % |

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

The Company generally does not retain long-term fixed rate residential mortgage loans in its portfolio. Fixed rate loans conforming to standards required by the secondary market are offered to qualified borrowers, but are not funded until the Company has a non-recourse purchase commitment from the secondary market at a predetermined price. During the nine months ended September 30, 2019, the Company sold approximately  $28.3 million of loans to investors, compared to $30.0 million for the nine months ended September 30, 2018. At September 30, 2019, the Company was servicing approximately $270.8 million of loans sold to the secondary market compared to $279.9 million at December 31, 2018, and $282.9 million at September 30, 2018.

*Risk Elements of the Loan Portfolio*

Management, the senior loan committee, and internal loan review, formally review all loans in excess of certain dollar amounts (periodically established) at least annually. Loans in excess of $2.0 million in aggregate and all adversely classified credits identified by management are reviewed by the senior loan committee. In addition, all other loans are reviewed on a risk weighted selection process. The senior loan committee reviews and reports to the board of directors, on a monthly basis, past due, classified, and watch list loans in order to classify or reclassify loans as loans requiring attention, substandard, doubtful, or loss. During this review, management also determines which loans should be considered impaired. Management follows the guidance provided in the FASB's ASC Topic 310-10-35 in identifying and measuring loan impairment. If management determines that it is probable that all amounts due on a loan will not be collected under the original terms of the loan agreement, the loan is considered impaired. These loans are evaluated individually for impairment, and in conjunction with current economic conditions and loss experience, specific reserves are estimated as further discussed below. Loans not individually evaluated are aggregated and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type, delinquencies, current economic conditions, loan risk ratings and industry concentration. Management believes, but there can be no assurance, that these procedures keep management informed of potential problem loans. Based upon these procedures, both the allowance and provision for loan losses are adjusted to maintain the allowance at a level considered necessary by management to provide for probable losses inherent in the loan portfolio.

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*Non-performing Assets*

The following table summarizes non-performing assets at the dates indicated:

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  | **September 30,** | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  | **2018** | |  |
| **Nonaccrual loans:** |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  | $ | 1,027 |  | $ | 1,857 |  | $ | 2,296 |  |
| Real estate construction - residential |  |  | — |  |  | — |  |  | — |  |
| Real estate construction - commercial |  |  | 145 |  |  | 153 |  |  | 158 |  |
| Real estate mortgage - residential |  |  | 2,158 |  |  | 2,720 |  |  | 2,768 |  |
| Real estate mortgage - commercial |  |  | 1,111 |  |  | 474 |  |  | 597 |  |
| Installment and other consumer |  |  | 123 |  |  | 210 |  |  | 226 |  |
| **Total** |  | $ | 4,564 |  | $ | 5,414 |  | $ | 6,045 |  |
| **Loans contractually past - due 90 days or more and still accruing:** |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  | $ | — |  | $ | — |  | $ | 8 |  |
| Real estate construction - residential |  |  | — |  |  | — |  |  | — |  |
| Real estate construction - commercial |  |  | — |  |  | — |  |  | — |  |
| Real estate mortgage - residential |  |  | 193 |  |  | 156 |  |  | 212 |  |
| Real estate mortgage - commercial |  |  | — |  |  | — |  |  | — |  |
| Installment and other consumer |  |  | 4 |  |  | 6 |  |  | 15 |  |
| **Total** |  | $ | 197 |  | $ | 162 |  | $ | 235 |  |
| **Total non-performing loans (a)** |  |  | 4,761 |  |  | 5,576 |  |  | 6,280 |  |
| **Other real estate owned and repossessed assets** |  |  | 12,878 |  |  | 13,691 |  |  | 13,373 |  |
| **Total non-performing assets** |  | $ | 17,639 |  | $ | 19,267 |  | $ | 19,653 |  |
|  |  |  |  |  |  |  |  |  |  |  |
| Loans (c) |  | $ | 1,149,268 |  | $ | 1,146,044 |  | $ | 1,115,641 |  |
| Allowance for loan losses to loans |  |  | 1.06 | % |  | 1.02 | % |  | 1.02 | % |
| Non-performing loans to loans (a) |  |  | 0.41 | % |  | 0.49 | % |  | 0.56 | % |
| Non-performing assets to loans (b) |  |  | 1.53 | % |  | 1.68 | % |  | 1.76 | % |
| Non-performing assets to assets (b) |  |  | 1.22 | % |  | 1.30 | % |  | 1.35 | % |
| Allowance for loan losses to non-performing loans |  |  | 255.79 | % |  | 208.97 | % |  | 180.86 | % |

|  |  |  |  |
| --- | --- | --- | --- |
|  | (a) |  | Non-performing loans include loans 90 days past due and accruing, nonaccrual loans, and non-performing TDRs included in nonaccrual loans. |

|  |  |  |  |
| --- | --- | --- | --- |
|  | (b) |  | Non-performing assets include non-performing loans and other real estate owned and repossessed assets. |

|  |  |  |  |
| --- | --- | --- | --- |
|  | (c) |  | Loan totals do not include loans held for sale. |

Total non-performing assets were $17.6 million, or 1.53% of total loans, at September 30, 2019 compared to $19.3 million, or 1.68% of total loans, at December 31, 2018, and $19.7 million, or 1.76% of total loans, at September 30, 2018, respectively. Non-accrual loans included $1.3 million of loans classified as TDRs at September 30, 2019 compared to $2.0 million and $2.2 million at December 31, 2018 and September 30, 2018, respectively.

As of September 30, 2019, approximately $5.9 million compared to $5.2 million and $5.6 million at December 31, 2018 and September 30, 2018, respectively, of loans classified as substandard, which include performing TDRs, and are not included in the nonperforming asset table, were identified as potential problem loans having more than normal risk which raised doubts as to the ability of the borrower to comply with present loan repayment terms. Management believes the general allowance was sufficient to cover the risks and probable losses related to such loans at September 30, 2019 and December 31, 2018, respectively.

Non-accrual loans decreased $850,000 to  $4.6 million at September 30, 2019 compared to $5.4 million December 31, 2018. Loans past due 90 days and still accruing interest at September 30, 2019, were $197,000 compared to $162,000 at December 31, 2018. Other real estate and repossessed assets were $12.9 million at September 30, 2019 compared to $13.7 million at December 31, 2018. During the nine months ended September 30, 2019, $411,000 of nonaccrual loans, net of

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charge-offs taken, moved to other real estate owned and repossessed assets compared to $589,000 during the nine months ended September 30, 2018.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **September 30, 2019** | | | | | | |  | **December 31, 2018** | | | | | | |  |
|  |  | **Number of** |  | **Recorded** | |  | **Specific** | |  | **Number of** |  | **Recorded** | |  | **Specific** | |  |
| *(In thousands)* |  | **contracts** |  | **Investment** | |  | **Reserves** | |  | **contracts** |  | **Investment** | |  | **Reserves** | |  |
| **Performing TDRs** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | 7 |  | $ | 551 |  | $ | 178 |  | 6 |  | $ | 570 |  | $ | 174 |  |
| Real estate mortgage - residential |  | 6 |  |  | 1,685 |  |  | 38 |  | 9 |  |  | 2,073 |  |  | 72 |  |
| Real estate mortgage - commercial |  | 2 |  |  | 358 |  |  | 7 |  | 2 |  |  | 377 |  |  | 8 |  |
| Installment and other consumer |  | 3 |  |  | 38 |  |  | 3 |  | 3 |  |  | 44 |  |  | 4 |  |
| **Total performing TDRs** |  | 18 |  | $ | 2,632 |  | $ | 226 |  | 20 |  | $ | 3,064 |  | $ | 258 |  |
| **Non-performing TDRs** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | 6 |  | $ | 526 |  | $ | 109 |  | 5 |  | $ | 1,042 |  | $ | 94 |  |
| Real estate mortgage - residential |  | 6 |  |  | 753 |  |  | 129 |  | 5 |  |  | 867 |  |  | 182 |  |
| Real estate mortgage - commercial |  | — |  |  | — |  |  | — |  | — |  |  | — |  |  | — |  |
| Installment and other consumer |  | 2 |  |  | 72 |  |  | 7 |  | 2 |  |  | 72 |  |  | 9 |  |
| **Total non-performing TDRs** |  | 14 |  | $ | 1,351 |  | $ | 245 |  | 12 |  | $ | 1,981 |  | $ | 285 |  |
| **Total TDRs** |  | 32 |  | $ | 3,983 |  | $ | 471 |  | 32 |  | $ | 5,045 |  | $ | 543 |  |

At September 30, 2019, loans classified as TDRs totaled $4.0 million, with $471,000 of specific reserves, of which $1.4 million were classified as non-performing TDRs and $2.6 million were classified as performing TDRs. This compared to $5.0 million of loans classified as TDRs, with $543,000 of specific reserves, of which $2.0 million were classified as non-performing TDRs and $3.0 million were classified as performing TDRs at December 31, 2018. Both performing and nonperforming TDRs are considered impaired loans. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan’s effective interest rate or the fair value of the underlying collateral less applicable selling costs if the loan is collateral dependent.  The net decrease in total TDRs from December 31, 2018 to September 30, 2019 was primarily due to $1.1 million of payments received on TDRs, partially offset by two new TDRs totaling $80,000. During the third quarter of 2019 commercial collateral sold contributed to the payments received.

**Allowance for Loan Losses and Provision**

*Allowance for Loan Losses*

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  |
| **Allocation of allowance for loan losses at end of period:** |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  | $ | 2,889 |  | $ | 3,237 |  |
| Real estate construction - residential |  |  | 84 |  |  | 140 |  |
| Real estate construction - commercial |  |  | 801 |  |  | 757 |  |
| Real estate mortgage - residential |  |  | 1,946 |  |  | 2,071 |  |
| Real estate mortgage - commercial |  |  | 6,095 |  |  | 4,914 |  |
| Installment and other consumer |  |  | 328 |  |  | 334 |  |
| Unallocated |  |  | 35 |  |  | 199 |  |
| **Total** |  | $ | 12,178 |  | $ | 11,652 |  |

The allowance for loan losses (ALL) was $12.2 million, or 1.06%, of loans outstanding at September 30, 2019 compared to $11.7 million, or 1.02%, at December 31, 2018, and $11.4 million, or 1.02%, of loans outstanding at September 30,

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2018. The ratio of the allowance for loan losses to nonperforming loans was 255.79% at September 30, 2019, compared to 208.97% at December 31, 2018, and 180.86% at September 30, 2018.

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  |
| **Allocation of allowance for loan losses:** |  |  |  |  |  |  |  |
| Individually evaluated for impairment - specific reserves |  | $ | 708 |  | $ | 1,194 |  |
| Collectively evaluated for impairment - general reserves |  |  | 11,470 |  |  | 10,458 |  |
| **Total** |  | $ | 12,178 |  | $ | 11,652 |  |

The *specific reserve component* applies to loans evaluated individually for impairment. The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals and/or internal evaluations, or by discounting the total expected future cash flows. Once the impairment amount is calculated, a specific reserve allocation is recorded. At September 30, 2019, $708,000 of the Company’s ALL was allocated to impaired loans totaling approximately $7.3 million compared to $1.2 million of the Company’s ALL allocated to impaired loans totaling approximately $8.5 million at December 31, 2018. Management determined that $1.6 million, or 23%, of total impaired loans required no reserve allocation at September 30, 2019 compared to $2.1 million, or 25%, at December 31, 2018, primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

The *incurred loss component* of the general reserve, or loans collectively evaluated for impairment, is determined by applying loss rates to pools of loans by asset type. Loans not individually evaluated are aggregated by risk characteristics and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type. In the first quarter 2019, management adjusted the look-back period to begin with loss history in the first quarter 2012 as the starting point through the current quarter and it will continue to include this starting point going forward. Management determined that with the extended current economic recovery, the look-back period should be expanded to include the current economic cycle. This increasing look-back period will then be adjusted once a loss producing downturn is recognized by allowing the look-back period to shift forward by eliminating the earliest loss period and replenishing it with losses from the most recent period. Prior to 2019, the Company utilized a five-year look-back period, which was considered a representative historical loss period. The look-back period is consistently evaluated for relevance given the current facts and circumstances.

These historical loss rates for each risk group are used as the starting point to determine loss rates for measurement purposes. The historical loan loss rates are multiplied by loss emergence periods (LEP) which represent the estimated time period between a borrower first experiencing financial difficulty and the recognition of a loss.

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

The specific and general reserve allocations represent management’s best estimate of probable losses inherent in the loan portfolio at the evaluation date. Although the allowance for loan losses is comprised of specific and general allocations, the entire allowance is available to absorb any credit losses.

The more significant changes from December 31, 2018 to September 30, 2019 in the allocations of the allowance for loan losses to the loan portfolios listed above included the following:

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Real estate mortgage – commercial increased by $1.2 million primarily due to higher historical loss rates resulting from extending the look-back period back to the first quarter 2012. Commercial, financial, and agriculture decreased by $348,000 primarily due to a reduction in the qualitative risk factors associated with this portfolio.

*Provision*

A  $450,000 and $850,000 provision was required for the three and nine months ended September 30, 2019,  respectively, compared to a $250,000 and $1.0 million provision for the three and nine and months ended September 30, 2018, respectively.  The increase from the three month comparative period resulted from the extended look back period implemented in 2019 that increased the historical loss component of the reserve. The decrease from the nine month comparative period was primarily due to slower loan growth in the current nine month period that resulted in a slower growth in the calculated allowance for loan losses.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended** | | | | |  | **Nine Months Ended** | | | | |  |
|  |  | **September 30,** | | | | |  | **September 30,** | | | | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  | **2019** | |  | **2018** | |  |
| **Analysis of allowance for loan losses:** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Balance beginning of period |  | $ | 11,883 |  | $ | 11,212 |  | $ | 11,652 |  | $ | 10,852 |  |
| **Charge-offs:** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  |  | 61 |  |  | 75 |  |  | 255 |  |  | 378 |  |
| Real estate construction - residential |  |  | — |  |  | — |  |  | — |  |  | 48 |  |
| Real estate construction - commercial |  |  | — |  |  | — |  |  | — |  |  | 30 |  |
| Real estate mortgage - residential |  |  | 86 |  |  | 32 |  |  | 266 |  |  | 64 |  |
| Real estate mortgage - commercial |  |  | 6 |  |  | 5 |  |  | 21 |  |  | 34 |  |
| Installment and other consumer |  |  | 60 |  |  | 74 |  |  | 151 |  |  | 181 |  |
| **Total charge-offs** |  |  | 213 |  |  | 186 |  |  | 693 |  |  | 735 |  |
| **Recoveries:** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  | $ | 12 |  | $ | 38 |  | $ | 139 |  | $ | 61 |  |
| Real estate construction - residential |  |  | 12 |  |  | 13 |  |  | 25 |  |  | 38 |  |
| Real estate construction - commercial |  |  | — |  |  | — |  |  | — |  |  | — |  |
| Real estate mortgage - residential |  |  | 8 |  |  | 9 |  |  | 111 |  |  | 44 |  |
| Real estate mortgage - commercial |  |  | 7 |  |  | 2 |  |  | 9 |  |  | 34 |  |
| Installment and other consumer |  |  | 19 |  |  | 20 |  |  | 85 |  |  | 64 |  |
| **Total recoveries** |  |  | 58 |  |  | 82 |  |  | 369 |  |  | 241 |  |
| **Net charge-offs** |  |  | **155** |  |  | **104** |  |  | **324** |  |  | **494** |  |
| Provision for loan losses |  |  | 450 |  |  | 250 |  |  | 850 |  |  | 1,000 |  |
| **Balance end of period** |  | $ | 12,178 |  | $ | 11,358 |  | $ | 12,178 |  | $ | 11,358 |  |

*Net Loan Charge-offs*

The Company’s net charge-offs were $155,000, or 0.01%, and $324,000, or 0.03%, of average loans for the three and nine months ended September 30, 2019 compared to net charge-offs of  $104,000, or 0.01%, and $494,000, or 0.05%, of average loans for the three and nine months ended September 30, 2018.

The decrease in net charge-offs for the nine months ended September 30, 2019 compared to the nine months ended September 30, 2018 was due to a $128,000 increase in recoveries primarily related to one commercial loan relationship recovery and one real estate mortgage – residential recovery received during the first quarter of 2019.

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***Liquidity and Capital Resources***

**Liquidity Management**

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

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

The Company has a number of sources of funds to meet liquidity needs on a daily basis. The Company’s most liquid assets are comprised of available for sale investment securities, not including other debt securities, federal funds sold, and excess reserves held at the Federal Reserve.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  |
| Federal funds sold and other overnight interest-bearing deposits |  | $ | 21,559 |  | $ | 18,396 |  |
| Certificates of deposit in other banks |  |  | 11,601 |  |  | 12,247 |  |
| Available-for-sale investment securities |  |  | 181,270 |  |  | 218,205 |  |
| **Total** |  | $ | 214,430 |  | $ | 248,848 |  |

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 $181.3 million at September 30, 2019 and included an unrealized net loss of $84,000. The portfolio includes projected maturities and mortgage backed securities pay-downs of approximately $10.3 million over the next twelve months, which offer resources to meet either new loan demand or reductions in the Company’s deposit base.

The Company pledges portions of its investment securities portfolio to secure public fund deposits, federal funds purchase lines, securities sold under agreements to repurchase, borrowing capacity at the Federal Reserve Bank, and for other purposes required by law. At September 30, 2019 and December 31, 2018, the Company’s unpledged securities in the available for sale portfolio totaled approximately $63.4 million and $65.2 million, respectively.

Total investment securities pledged for these purposes were as follows:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  |
| **Investment securities pledged for the purpose of securing:** |  |  |  |  |  |  |  |
| Federal Reserve Bank borrowings |  | $ | 9,654 |  | $ | 9,397 |  |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 36,634 |  |  | 32,529 |  |
| Other deposits |  |  | 71,562 |  |  | 111,090 |  |
| **Total pledged, at fair value** |  | $ | 117,850 |  | $ | 153,016 |  |

Liquidity is available from the Company’s base of core customer deposits, defined as demand, interest checking, savings, money market deposit accounts, and time deposits less than $250,000, less all brokered deposits under $250,000. At September 30, 2019, such deposits totaled $1.0 billion and represented 88.0% of the Company’s total deposits. These core deposits are normally less volatile and are often tied to other products of the Company through long lasting relationships.

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Core deposits at September 30, 2019 and December 31, 2018 were as follows:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  |
| **Core deposit base:** |  |  |  |  |  |  |  |
| Non-interest bearing demand |  | $ | 284,452 |  | $ | 262,857 |  |
| Interest checking |  |  | 170,661 |  |  | 215,432 |  |
| Savings and money market |  |  | 347,455 |  |  | 378,484 |  |
| Other time deposits |  |  | 198,705 |  |  | 211,715 |  |
| **Total** |  | $ | 1,001,273 |  | $ | 1,068,488 |  |

Time deposits and certificates of deposit of $250,000 and greater at September 30, 2019 and December 31, 2018 were $95.0 million and $104.9 million, respectively. The Company had brokered deposits totaling $37.3 million and $39.8 million at September 30, 2019 and December 31, 2018, respectively.

Other components of liquidity are the level of borrowings from third party sources and the availability of future credit. The Company’s outside borrowings are comprised of securities sold under agreements to repurchase, Federal Home Loan Bank advances, and subordinated notes. Federal funds purchased are overnight borrowings obtained mainly from upstream correspondent banks with which the Company maintains approved credit lines. As of September 30, 2019, under agreements with these unaffiliated banks, the Bank may borrow up to $50.0 million in federal funds on an unsecured basis and $16.3 million on a secured basis. There were no federal funds purchased outstanding at September 30, 2019. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of the Company’s investment portfolio. At September 30, 2019, there were  $27.2 million in repurchase agreements. The Company may periodically borrow additional short-term funds from the Federal Reserve Bank through the discount window, although no such borrowings were outstanding at September 30, 2019.

The Bank is a member of the Federal Home Loan Bank of Des Moines (FHLB) and has access to credit products of the FHLB. As of September 30, 2019, the Bank had $107.0 million in outstanding borrowings with the FHLB. In addition, the Company has $49.5 million in outstanding subordinated notes issued to wholly-owned grantor trusts, funded by preferred securities issued by the trusts.

Borrowings outstanding at September 30, 2019 and December 31, 2018 were as follows:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **September 30,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2019** | |  | **2018** | |  |
| **Borrowings:** |  |  |  |  |  |  |  |
| Federal funds purchased and securities sold under agreements to repurchase |  | $ | 27,191 |  | $ | 24,647 |  |
| Federal Home Loan Bank advances |  |  | 106,953 |  |  | 95,126 |  |
| Subordinated notes |  |  | 49,486 |  |  | 49,486 |  |
| Other borrowings |  |  | 27 |  |  | 27 |  |
| **Total** |  | $ | 183,657 |  | $ | 169,286 |  |

The Company pledges certain assets, including loans and investment securities to the Federal Reserve Bank, FHLB, and other correspondent banks as security to establish lines of credit and borrow from these entities. Based on the type and value of collateral pledged, the FHLB establishes a collateral value from which the Company may draw advances against this collateral. This collateral is also used to enable the FHLB to issue letters of credit in favor of public fund depositors of the Company. The Federal Reserve Bank also establishes a collateral value of assets pledged to support borrowings from the discount window. The following table reflects collateral value of assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to the Company as follows:

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|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **September 30,** | | | | | | | | | | |  | **December 31,** | | | | | | | | | | |
|  |  | **2019** | | | | | | | | | | |  | **2018** | | | | | | | | | | |
|  |  |  |  |  |  |  |  | **Federal** | |  |  |  |  |  |  |  |  |  |  | **Federal** | |  |  |  |
|  |  |  |  |  |  |  |  | **Funds** | |  |  |  |  |  |  |  |  |  |  | **Funds** | |  |  |  |
|  |  |  |  |  | **Federal** | |  | **Purchased** | |  |  |  |  |  |  |  | **Federal** | |  | **Purchased** | |  |  |  |
| *(In thousands)* |  | **FHLB** | |  | **Reserve Bank** | |  | **Lines** | |  | **Total** | |  | **FHLB** | |  | **Reserve Bank** | |  | **Lines** | |  | **Total** | |
| Advance equivalent |  | $ | 285,047 |  | $ | 9,452 |  | $ | 56,858 |  | $ | 351,357 |  | $ | 301,606 |  | $ | 9,160 |  | $ | 57,235 |  | $ | 368,001 |
| Letters of credit |  |  | (70,250) |  |  | — |  |  | — |  |  | (70,250) |  |  | (80,000) |  |  | — |  |  | — |  |  | (80,000) |
| Advances outstanding |  |  | (106,953) |  |  | — |  |  | — |  |  | (106,953) |  |  | (95,126) |  |  | — |  |  | (8,000) |  |  | (103,126) |
| **Total available** |  | $ | 107,844 |  | $ | 9,452 |  | $ | 56,858 |  | $ | 174,154 |  | $ | 126,480 |  | $ | 9,160 |  | $ | 49,235 |  | $ | 184,875 |

At September 30, 2019, loans of $501.0 million were pledged at the Federal Home Loan Bank as collateral for borrowings and letters of credit. At September 30, 2019, investments totaling $18.6 million were pledged to secure federal funds purchase lines and borrowing capacity at the Federal Reserve Bank.

**Sources and Uses of Funds**

Cash and cash equivalents were $44.4 million at September 30, 2019 compared to $42.1 million at December 31, 2018. The $2.3 million increase resulted from changes in the various cash flows produced by operating, investing, and financing activities of the Company, as shown in the accompanying consolidated statement of cash flows for the nine months ended September 30, 2019. Cash flow provided from operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of $11.1 million for the nine months ended September 30, 2019.

Investing activities consisting mainly of purchases, sales and maturities of available-for-sale securities, and changes in the level of the loan portfolio provided total cash of $29.2 million. The cash inflow primarily consisted of $60.6 million from maturities, calls, and sales of investment securities, partially offset by $20.4 million purchases of investment securities, $6.7 million payment for the branch sale, and $4.0 increase in loans.

Financing activities used cash of $38.0 million, resulting primarily from a $60.4 million decrease in interest bearing transaction accounts, and a $17.3 million decrease in time deposits, partially offset by a $27.3 million increase in demand deposits, and an $11.8 million increase in net FHLB advances. Future short-term liquidity needs arising from daily operations are not expected to vary significantly during 2019.

In the normal course of business, the Company enters into certain forms of off-balance sheet transactions, including unfunded loan commitments and letters of credit. These transactions are managed through the Company’s various risk management processes. Management considers both on-balance sheet and off-balance sheet transactions in its evaluation of the Company’s liquidity. The Company had $325.9 million in unused loan commitments and standby letters of credit as of September 30, 2019. Although the Company’s current liquidity resources are adequate to fund this commitment level the nature of these commitments is such that the likelihood of such a funding demand is very low.

The Company is a legal entity, separate and distinct from the Bank, which must provide its own liquidity to meet its operating needs. The Company’s ongoing liquidity needs primarily include funding its operating expenses and paying cash dividends to its shareholders. The Company paid cash dividends to its shareholders totaling approximately $1.9 million and $1.4 million for the nine months ended September 30, 2019 and 2018, respectively. A large portion of the Company’s liquidity is obtained from the Bank in the form of dividends. The Bank declared and paid $5.5 million and $5.0 million in dividends to the Company during the nine months ended September 30, 2019 and 2018, respectively. At September 30, 2019 and December 31, 2018, the Company had cash and cash equivalents totaling $1.4 million and $1.3 million, respectively.

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**Capital Management**

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

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

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. Institutions that do not maintain the required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital conservation buffer requirement will be phased in over four years beginning in 2016. The capital conservation buffer was phased in from  0.625% of risk-weighted assets beginning January 1, 2016 to 2.5% of risk weighted-assets by January 1, 2019. The capital conservation buffer requirement effectively raises the minimum required risk-based capital ratios to 7% Common Equity Tier 1 Capital, 8.5% Tier 1 Capital and 10.5% Total Capital on a fully phased-in basis. Under the Basel III requirements, at September 30, 2019 and December 31, 2018, the Company met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well-capitalized institutions, as shown in the following table as of periods indicated:

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|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  | | | |  |  | | | |  |
|  |  |  |  |  |  |  | **Required for Capital** | | | |  | **Well-Capitalized** | | | |  | **Minimum Capital** | | | |  |
|  |  | **Actual** | | | |  | **Adequacy Purposes** | | | |  | **Standard** | | | |  | **Requirement** | | | |  |
| ***(in thousands)*** |  | **Amount** | |  | **Ratio** |  | **Amount** | |  | **Ratio** |  | **Amount** | |  | **Ratio** |  | **Amount** | |  | **Ratio** |  |
| **September 30, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Total Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 175,816 |  | 14.47 | % | $ | 97,199 |  | 8.00 | % | $ | N.A. |  | N.A | % | $ | N.A. |  | N.A | % |
| Bank |  |  | 172,929 |  | 14.27 |  |  | 96,921 |  | 8.00 |  |  | 121,151 |  | 10.00 |  |  | 127,209 |  | 10.50 |  |
| **Tier 1 Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 153,083 |  | 12.60 | % | $ | 72,899 |  | 6.00 | % | $ | N.A. |  | N.A | % | $ | N.A. |  | N.A | % |
| Bank |  |  | 160,591 |  | 13.26 |  |  | 72,691 |  | 6.00 |  |  | 96,921 |  | 8.00 |  |  | 102,979 |  | 8.50 |  |
| **Common Equity Tier 1 Capital (to risk-weighted assets)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 115,478 |  | 9.50 | % | $ | 54,674 |  | 4.50 | % | $ | N.A. |  | N.A | % | $ | N.A. |  | N.A | % |
| Bank |  |  | 160,591 |  | 13.26 |  |  | 54,518 |  | 4.50 |  |  | 78,748 |  | 6.50 |  |  | 84,806 |  | 7.00 |  |
| **Tier 1 Capital (to adjusted average assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 153,083 |  | 10.69 | % | $ | 57,276 |  | 4.00 | % | $ | N.A. |  | N.A | % | $ | N.A. |  | N.A | % |
| Bank |  |  | 160,591 |  | 11.27 |  |  | 57,008 |  | 4.00 |  |  | 71,260 |  | 5.00 |  |  | 57,008 |  | 4.00 |  |
| ***(in thousands)*** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **December 31, 2018** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Total Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 165,325 |  | 13.28 | % | $ | 99,578 |  | 8.00 | % | $ | N.A. |  | N.A. | % | $ | N.A. |  | N.A | % |
| Bank |  |  | 163,814 |  | 13.19 |  |  | 99,327 |  | 8.00 |  |  | 124,159 |  | 10.00 |  |  | 130,367 |  | 10.50 |  |
| **Tier 1 Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 139,532 |  | 11.21 | % | $ | 74,683 |  | 6.00 | % | $ | N.A. |  | N.A. | % | $ | N.A. |  | N.A | % |
| Bank |  |  | 152,002 |  | 12.24 |  |  | 74,495 |  | 6.00 |  |  | 99,327 |  | 8.00 |  |  | 105,535 |  | 8.50 |  |
| **Common Equity Tier 1 Capital (to risk-weighted assets)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 105,513 |  | 8.48 | % | $ | 56,013 |  | 4.50 | % | $ | N.A. |  | N.A. | % | $ | N.A. |  | N.A | % |
| Bank |  |  | 152,002 |  | 12.24 |  |  | 55,872 |  | 4.50 |  |  | 80,703 |  | 6.50 |  |  | 86,911 |  | 7.00 |  |
| **Tier 1 leverage ratio:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 139,532 |  | 9.55 | % | $ | 58,467 |  | 4.00 | % | $ | N.A. |  | N.A. | % | $ | N.A. |  | N.A | % |
| Bank |  |  | 152,002 |  | 10.43 |  |  | 58,272 |  | 4.00 |  |  | 72,839 |  | 5.00 |  |  | 58,272 |  | 4.00 |  |

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

**Asset/Liability and Interest Rate Risk**

Management and the Board of Directors are responsible for managing interest rate risk and employing risk management policies that monitor and limit this exposure. Interest rate risk is measured using net interest income simulations and market value of portfolio equity analyses. These analyses use various assumptions, including the nature and timing of interest rate changes, yield curve shape, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, and reinvestment/replacement of asset and liability cash flows.

The principal objective of the Company’s asset and liability management function is to evaluate the interest rate risk within the balance sheet and pursue a controlled assumption of interest rate risk while maximizing earnings and preserving

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adequate levels of liquidity and capital. The asset and liability management function is under the guidance of the Asset Liability Committee from direction of the Board of Directors. The Asset Liability Committee meets monthly to review, among other things, the sensitivity of the Company’s assets and liabilities to interest rate changes, local and national market conditions and rates. The Asset Liability Committee also reviews the liquidity, capital, deposit mix, loan mix and investment positions of the Company.

Instantaneous parallel rate shift scenarios are modeled and utilized to evaluate risk and establish exposure limits for acceptable changes in net interest margin. These scenarios, known as rate shocks, simulate an instantaneous change in interest rates and use various assumptions, including, but not limited to, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment and replacement of asset and liability cash flows.

Management analyzes the economic value of equity as a secondary measure of interest rate risk. This is a complementary measure to net interest income where the calculated value is the result of the market value of assets less the market value of liabilities. The economic value of equity is a longer term view of interest rate risk because it measures the present value of the future cash flows. The impact of changes in interest rates on this calculation is analyzed for the risk to our future earnings and is used in conjunction with the analyses on net interest income.

The table below illustrates the impact of an immediate and sustained 200 and 100 basis point increase and a 200 and 100 basis point decrease in interest rates on net interest income based on the interest rate risk model at September 30, 2019 and December 31, 2018.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
|  |  | **% Change in projected net interest income** | | | | | |
| **Hypothetical shift in interest rates** |  | **September 30,** | | | **December 31,** | | |
| ***(bps)*** |  | **2019** | | | **2018** | | |
| 200 |  |  | (0.97) | % |  | 0.26 | % |
| 100 |  |  | 0.21 | % |  | 1.17 | % |
| (100) |  |  | 1.04 | % |  | 3.39 | % |
| (200) |  |  | 0.28 | % |  | 4.19 | % |

The change in our interest rate risk exposure from December 31, 2018 to September 30, 2019 was primarily due to the Company’s balance sheet becoming more balanced between rate sensitive assets and rate sensitive liabilities. The change in projected net interest income from interest rate shifts of up 200 bps and down 200 bps does not exceed 104 bps, which is considered a minimal level of interest rate risk.

Many assumptions are used to calculate the impact of interest rate fluctuations. Actual results may be significantly different than our projections due to several factors, including the timing and frequency of rate changes, market conditions and the shape of the yield curve. The computations of interest rate risk shown above do not include actions that management may undertake to manage the risks in response to anticipated changes in interest rates and actual results may also differ due to any actions taken in response to the changing rates.

**Effects of Inflation**

The effects of inflation on financial institutions are different from the effects on other commercial enterprises since financial institutions make few significant capital or inventory expenditures, which are directly affected by changing prices. Because bank assets and liabilities are virtually all monetary in nature, inflation does not affect a financial institution as much as do changes in interest rates. The general level of inflation does underlie the general level of most interest rates, but interest rates do not increase at the rate of inflation as do prices of goods and services. Rather, interest rates react more to changes in the expected rate of inflation and to changes in monetary and fiscal policy.

Inflation does have an impact on the growth of total assets in the banking industry, often resulting in a need to increase capital at higher than normal rates to maintain an appropriate capital to asset ratio. In the opinion of management, inflation did not have a significant effect on the Company’s operations for the three months ended September 30, 2019.

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**Item 4. Controls and Procedures**

Our Company’s management has evaluated, with the participation of our principal executive and principal financial officers, the effectiveness of our disclosure controls and procedures as defined in Rules 13a – 15(e) or 15d – 15(e) of the Securities Exchange Act of 1934 as of September 30, 2019. Based upon and as of the date of that evaluation, our principal executive and principal financial officers concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported as and when required. It should be noted that any system of disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any system of disclosure controls and procedures is based in part upon assumptions about the likelihood of future events. Because of these and other inherent limitations of any such system, there can be no assurance that any design will always succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

There has been no change in our Company’s internal control over financial reporting that occurred during the three months ended September 30, 2019 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Impact of New Accounting Standards**

***Intangibles*** In August 2018, the FASB issued ASU 2018‑15, *Intangibles - Goodwill and Other - Internal-Use Software (Topic 350‑40) Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract.* This ASU aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). ASU 2018‑15 is effective for annual reporting periods beginning after December 15, 2019 and is not expected to have a significant impact on the Company’s consolidated financial statements.

***Pension*** In August 2018, the FASB issued ASU 2018‑14, *Compensation - Retirement Benefits - Defined Benefit Plans -General (Subtopic 715-20) Disclosure Framework – Changes to the Disclosure Requirements for Defined Benefit Plans.* These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. ASU 2018‑14 is effective for annual reporting periods beginning after December 15, 2020 and is not expected to have a significant impact on the Company’s consolidated financial statements.

***Fair Value Measurement*** In August 2018, the FASB issued ASU 2018‑13, *Fair Value Measurement (Topic 820) - Changes to the Disclosure Requirements for Fair Value Measurement.* ASU 2018‑13 removes the requirement to disclose the amount of and reasons for transfers between Level 1 and Level 2 fair value measurement methodologies, the policy for timing of transfers between levels and the valuation processes for Level 3 fair value measurements. It also adds a requirement to disclose changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period and the range and weighted average of significant unobservable inputs used to develop Level 3 measurements. For certain unobservable inputs, entities may disclose other quantitative information in lieu of the weighted average if the other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop Level 3 fair value measurements. ASU 2018‑13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently evaluating the impact of the adoption on the Company’s consolidated financial statements and disclosures.

***Financial Instruments*** In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses* *(Topic 326):* *Measurement of Credit Losses on Financial Instruments* (CECL)*.* The revised accounting guidance will remove all recognition thresholds and will require a company to recognize an allowance for credit losses for the difference between the amortized cost basis of a financial instrument and the amount of amortized cost that the company expects to collect over the instrument's contractual life. It also amends the credit loss measurement guidance for available-for-sale debt securities and beneficial interests in securitized financial assets. This new accounting guidance will be effective for interim

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and annual reporting periods beginning after December 15, 2019. While the Company generally expects to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, the Company has not determined the magnitude of any such one-time adjustment or the overall impact of the new guidance on the Company's consolidated financial statements. The Company has formed a committee and is continuing to evaluate the impact of the ASU's adoption on the Company's consolidated financial statements by assessing different credit risk models.  As a result of the FASB issuing a delay in the implementation of this ASU, the Company will extend its evaluation process over the new implementation deadline of 2022.

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**PART II - OTHER INFORMATION**

|  |  |
| --- | --- |
|  |  |
| Item 1. | Legal Proceedings |
|  |  |
|  | The information required by this Item is set forth in *Commitments and Contingencies, Pending Litigation,* in our Company’s Notes to Consolidated Financial Statements (*unaudited)*  . |

|  |  |  |
| --- | --- | --- |
|  |  |  |
| Item 1A. | Risk Factors | None |
|  |  |  |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds |  |
|  | On September 18, 2019, the Company's Board of Directors authorized the purchase of up to $5.0 million market value of the Company's common stock. Management was given discretion to determine the number and pricing of the shares to be purchased, as well as, the timing of any such purchases. During the three months ended September 30, 2019, no shares of the Company's common stock were purchased by or on behalf of the Company or affiliated purchasers. |  |
| Item 3. | Defaults Upon Senior Securities | None |
|  |  |  |
| Item 4. | Mine Safety Disclosures | None |
|  |  |  |
| Item 5. | Other Information | None |
|  |  |  |
| Item 6. | Exhibits |  |

|  |  |  |
| --- | --- | --- |
|  |  |  |
| **Exhibit No.** |  | **Description** |
| 3.1 |  | [Restated Articles of Incorporation of the Company (filed as Exhibit 3.1 to the Company’s current report on Form 8‑K on August 9, 2007 and incorporated herein by reference)](http://www.sec.gov/Archives/edgar/data/893847/000129993307004833/exhibit1.htm). |
| 3.2 |  | [Amended and Restated Bylaws of the Company (filed as Exhibit 3.1 to the Company’s current report on Form 8‑K on June 8, 2009 and incorporated herein by reference).](http://www.sec.gov/Archives/edgar/data/893847/000129993309002491/exhibit1.htm) |
| 4.1 |  | [Specimen certificate representing shares of the Company’s $1.00 par value Common Stock (filed as Exhibit 4.1 to the Company’s current report on Form 8‑K/A on June 23, 2017 and incorporated herein by reference).](http://www.sec.gov/Archives/edgar/data/893847/000141588917001027/form8k-06232017_100638.htm) |
| 31.1 |  | [Certificate of the Chief Executive Officer of the Company pursuant to Rule 13a‑14(a) or 15d‑14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.](hwbk-20190930ex311786b66.htm) |
| 31.2 |  | [Certificate of the Chief Financial Officer of the Company pursuant to Rule 13a‑14(a) or 15d‑14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.](hwbk-20190930ex312c42976.htm) |
| 32.1 |  | [Certificate of the Chief Executive Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002](hwbk-20190930ex321e504b9.htm). |
| 32.2 |  | [Certificate of the Chief Financial Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.](hwbk-20190930ex3229f0285.htm) |
| 101 |  | Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Changes in Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to Consolidated Financial Statements, tagged as blocks of text and in detail (XBRL). |

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HAWTHORN BANCSHARES, INC.

INDEX TO EXHIBITS

September 30, 2019 Form 10‑Q

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|  |  |  |
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\*This information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933, as amended, and Section 18 of the Securities Exchange Act of 1934, as amended.

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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.

|  |  |
| --- | --- |
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|  | **HAWTHORN BANCSHARES, INC.** |
|  |  |
| Date |  |
|  |  |
|  | /s/ David T. Turner |
|  |  |
| November  07, 2019 | David T. Turner, Chairman of the Board and |
|  | Chief Executive Officer (Principal Executive Officer) |
|  |  |
|  | /s/ W. Bruce Phelps |
|  |  |
| November 07, 2019 | W. Bruce Phelps, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) |
|  |  |

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