**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

*(Mark One)*

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

For the quarterly period ended March 31, 2020

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 May 7, 2020, the registrant had 6,241,302 shares of common stock, par value $1.00 per share, outstanding.

**PART I – FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Balance Sheets**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |
| (In thousands, except per share data) |  | **2020** | |  | **2019** | |
|  |  | *(Unaudited)* | |  |  | |
| **ASSETS** |  |  |  |  |  |  |
| Cash and due from banks |  | $ | 16,676 |  | $ | 22,576 |
| Federal funds sold and other interest-bearing deposits |  |  | 58,619 |  |  | 55,545 |
| Cash and cash equivalents |  |  | 75,295 |  |  | 78,121 |
| Certificates of deposit in other banks |  |  | 11,106 |  |  | 10,862 |
| Available-for-sale debt securities, at fair value |  |  | 198,049 |  |  | 175,093 |
| Other investments |  |  | 7,296 |  |  | 5,808 |
| **Total investment securities** |  |  | 205,345 |  |  | 180,901 |
| Loans held for investment |  |  | 1,180,522 |  |  | 1,168,797 |
| Allowances for loan losses |  |  | (15,693) |  |  | (12,477) |
| **Net loans** |  |  | 1,164,829 |  |  | 1,156,320 |
| Loans held for sale, at lower of cost or fair value |  |  | 4,286 |  |  | 428 |
| Premises and equipment - net |  |  | 35,092 |  |  | 35,388 |
| Mortgage servicing rights |  |  | 2,274 |  |  | 2,482 |
| Other real estate owned - net |  |  | 12,769 |  |  | 12,781 |
| Accrued interest receivable |  |  | 6,263 |  |  | 6,481 |
| Cash surrender value - life insurance |  |  | 2,411 |  |  | 2,398 |
| Other assets |  |  | 6,828 |  |  | 6,800 |
| **Total assets** |  | $ | 1,526,498 |  | $ | 1,492,962 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** |  |  |  |  |  |  |
| Deposits |  |  |  |  |  |  |
| Non-interest bearing demand |  | $ | 272,578 |  | $ | 261,166 |
| Savings, interest checking and money market |  |  | 596,294 |  |  | 614,331 |
| Time deposits $250,000 and over |  |  | 111,779 |  |  | 104,262 |
| Other time deposits |  |  | 198,920 |  |  | 206,762 |
| **Total deposits** |  |  | 1,179,571 |  |  | 1,186,521 |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 30,764 |  |  | 27,272 |
| Federal Home Loan Bank advances and other borrowings |  |  | 133,861 |  |  | 96,919 |
| Subordinated notes |  |  | 49,486 |  |  | 49,486 |
| Operating lease liabilities |  |  | 2,162 |  |  | 2,224 |
| Accrued interest payable |  |  | 780 |  |  | 1,136 |
| Other liabilities |  |  | 13,204 |  |  | 14,366 |
| **Total liabilities** |  |  | 1,409,828 |  |  | 1,377,924 |
| Stockholders’ equity: |  |  |  |  |  |  |
| Common stock, $1 par value, authorized 15,000,000 shares; issued 6,519,874 shares |  |  | 6,520 |  |  | 6,520 |
| Surplus |  |  | 55,727 |  |  | 55,727 |
| Retained earnings |  |  | 61,708 |  |  | 61,590 |
| Accumulated other comprehensive loss, net of tax |  |  | (1,522) |  |  | (3,755) |
| Treasury stock; 278,572, and 243,638 shares, at cost, respectively |  |  | (5,763) |  |  | (5,044) |
| **Total stockholders’ equity** |  |  | 116,670 |  |  | 115,038 |
| **Total liabilities and stockholders’ equity** |  | $ | 1,526,498 |  | $ | 1,492,962 |

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** | | | | |
|  |  | **March 31,** | | | | |
| ***(In thousands, except per share amounts)*** |  | **2020** | |  | **2019** | |
| **INTEREST INCOME** |  |  |  |  |  |  |
| Interest and fees on loans |  | $ | 14,422 |  | $ | 14,106 |
| Interest and fees on loans held for sale |  |  | 5 |  |  | — |
| Interest on investment securities: |  |  |  |  |  |  |
| Taxable |  |  | 813 |  |  | 1,000 |
| Nontaxable |  |  | 142 |  |  | 141 |
| Federal funds sold, other interest-bearing deposits, and certificates of deposit in other banks |  |  | 326 |  |  | 602 |
| Dividends on other investments |  |  | 100 |  |  | 66 |
| **Total interest income** |  |  | 15,808 |  |  | 15,915 |
| **INTEREST EXPENSE** |  |  |  |  |  |  |
| Interest on deposits: |  |  |  |  |  |  |
| Savings, interest checking and money market |  |  | 947 |  |  | 1,716 |
| Time deposit accounts $250,000 and over |  |  | 413 |  |  | 665 |
| Time deposits |  |  | 752 |  |  | 706 |
| **Total interest expense on deposits** |  |  | 2,112 |  |  | 3,087 |
| Interest on federal funds purchased and securities sold under agreements to repurchase |  |  | 37 |  |  | 33 |
| Interest on Federal Home Loan Bank advances |  |  | 632 |  |  | 542 |
| Interest on subordinated notes |  |  | 501 |  |  | 624 |
| **Total interest expense on borrowings** |  |  | 1,170 |  |  | 1,199 |
| **Total interest expense** |  |  | 3,282 |  |  | 4,286 |
| **Net interest income** |  |  | 12,526 |  |  | 11,629 |
| Provision for loan losses |  |  | 3,300 |  |  | 150 |
| **Net interest income after provision for loan losses** |  |  | 9,226 |  |  | 11,479 |
| **NON-INTEREST INCOME** |  |  |  |  |  |  |
| Service charges and other fees |  |  | 799 |  |  | 862 |
| Bank card income and fees |  |  | 693 |  |  | 695 |
| Trust department income |  |  | 379 |  |  | 293 |
| Real estate servicing fees, net |  |  | (87) |  |  | 84 |
| Gain on sale of mortgage loans, net |  |  | 419 |  |  | 105 |
| Other |  |  | 45 |  |  | 52 |
| **Total non-interest income** |  |  | 2,248 |  |  | 2,091 |
| **Investment securities (losses) gains, net** |  |  | (1) |  |  | 1 |
| **Gain on branch sale, net** |  |  | — |  |  | 2,074 |
| **NON-INTEREST EXPENSE** |  |  |  |  |  |  |
| Salaries and employee benefits |  |  | 6,121 |  |  | 5,438 |
| Occupancy expense, net |  |  | 766 |  |  | 698 |
| Furniture and equipment expense |  |  | 695 |  |  | 809 |
| Processing, network, and bank card expense |  |  | 976 |  |  | 1,001 |
| Legal, examination, and professional fees |  |  | 367 |  |  | 329 |
| Advertising and promotion |  |  | 249 |  |  | 258 |
| Postage, printing, and supplies |  |  | 241 |  |  | 210 |
| Other |  |  | 1,033 |  |  | 1,145 |
| **Total non-interest expense** |  |  | 10,448 |  |  | 9,888 |
| Income before income taxes |  |  | 1,025 |  |  | 5,757 |
| Income tax expense |  |  | 157 |  |  | 1,091 |
| **Net income** |  | $ | 868 |  |  | 4,666 |
| Basic earnings per share |  | $ | 0.14 |  | $ | 0.74 |
| Diluted earnings per share |  | $ | 0.14 |  | $ | 0.74 |

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** | | | | |
|  |  | **March 31,** | | | | |
| ***(In thousands)*** |  | **2020** | |  | **2019** | |
| Net income |  | $ | 868 |  | $ | 4,666 |
| Other comprehensive income, net of tax |  |  |  |  |  |  |
| Investment securities available-for-sale: |  |  |  |  |  |  |
| Unrealized gains on investment securities available-for-sale, net of tax |  |  | 2,180 |  |  | 1,378 |
| Defined benefit pension plans: |  |  |  |  |  |  |
| Amortization of prior service cost included in net periodic pension cost, net of tax |  |  | 53 |  |  | 15 |
| Total other comprehensive income |  |  | 2,233 |  |  | 1,393 |
| Total comprehensive income |  | $ | 3,101 |  | $ | 6,059 |

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, December 31, 2018** |  | $ | 6,279 |  | $ | 50,173 |  | $ | 54,105 |  | $ | (6,099) |  | $ | (5,044) |  | $ | 99,414 |
| Net income |  |  | — |  |  | — |  |  | 4,666 |  |  | — |  |  | — |  |  | 4,666 |
| Other comprehensive income |  |  | — |  |  | — |  |  | — |  |  | 1,393 |  |  | — |  |  | 1,393 |
| Cash dividends declared, common stock ($0.10 per share) |  |  | — |  |  | — |  |  | (603) |  |  | — |  |  | — |  |  | (603) |
| **Balance, March 31, 2019** |  | $ | 6,279 |  | $ | 50,173 |  | $ | 58,168 |  | $ | (4,706) |  | $ | (5,044) |  | $ | 104,870 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Balance, December 31, 2019** |  | $ | 6,520 |  | $ | 55,727 |  | $ | 61,590 |  | $ | (3,755) |  | $ | (5,044) |  | $ | 115,038 |
| Net income |  |  | — |  |  | — |  |  | 868 |  |  | — |  |  | — |  |  | 868 |
| Other comprehensive income |  |  | — |  |  | — |  |  | — |  |  | 2,233 |  |  | — |  |  | 2,233 |
| Purchase of treasury stock |  |  | — |  |  | — |  |  | — |  |  | — |  |  | (719) |  |  | (719) |
| Cash dividends declared, common stock ($0.12 per share) |  |  | — |  |  | — |  |  | (750) |  |  | — |  |  | — |  |  | (750) |
| **Balance, March 31, 2020** |  | $ | 6,520 |  | $ | 55,727 |  | $ | 61,708 |  | $ | (1,522) |  | $ | (5,763) |  | $ | 116,670 |

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

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**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | |
| ***(In thousands)*** |  | **2020** | |  | **2019** | |
| **Cash flows from operating activities:** |  |  |  |  |  |  |
| Net income |  | $ | 868 |  | $ | 4,666 |
| Adjustments to reconcile net income to net cash (used in)  provided by operating activities: |  |  |  |  |  |  |
| Provision for loan losses |  |  | 3,300 |  |  | 150 |
| Depreciation expense |  |  | 562 |  |  | 464 |
| Net amortization of investment securities, premiums, and discounts |  |  | 312 |  |  | 309 |
| Change in fair value of mortgage servicing rights |  |  | 275 |  |  | 94 |
| Investment securities (losses) gains, net |  |  | 1 |  |  | (1) |
| (Gains) losses on sales and dispositions of premises and equipment |  |  | (55) |  |  | 19 |
| Gain on sales and dispositions of other real estate |  |  | — |  |  | (6) |
| Gain on branch sale, net |  |  | — |  |  | (2,074) |
| Provision for other real estate owned |  |  | 12 |  |  | 28 |
| Decrease in accrued interest receivable |  |  | 218 |  |  | 2 |
| Increase in cash surrender value - life insurance |  |  | (13) |  |  | (20) |
| (Increase) decrease in other assets |  |  | (312) |  |  | 1,180 |
| Operating lease liabilities |  |  | (62) |  |  | (22) |
| (Decrease) increase in accrued interest payable |  |  | (356) |  |  | 58 |
| Decrease in other liabilities |  |  | (1,367) |  |  | (729) |
| Origination of mortgage loans for sale |  |  | (16,609) |  |  | (5,420) |
| Proceeds from the sale of mortgage loans |  |  | 13,170 |  |  | 5,096 |
| Gain on sale of mortgage loans, net |  |  | (419) |  |  | (105) |
| Other, net |  |  | (67) |  |  | (38) |
| **Net cash (used in) provided by operating activities** |  |  | (542) |  |  | 3,651 |
| **Cash flows from investing activities:** |  |  |  |  |  |  |
| Purchase of certificates of deposit in other banks |  |  | (735) |  |  | (494) |
| Proceeds from maturities of certificates of deposit in other banks |  |  | 491 |  |  | — |
| Net increase in loans |  |  | (11,809) |  |  | (7,669) |
| Purchase of available-for-sale debt securities |  |  | (43,984) |  |  | (12,748) |
| Proceeds from maturities of available-for-sale debt securities |  |  | 13,860 |  |  | 10,030 |
| Proceeds from calls of available-for-sale debt securities |  |  | 8,935 |  |  | 3,820 |
| Proceeds from sales of available-for-sale debt securities |  |  | 681 |  |  | — |
| Purchases of FHLB stock |  |  | (1,491) |  |  | (62) |
| Proceeds from sales of FHLB stock |  |  | 2 |  |  | 3 |
| Purchases of premises and equipment |  |  | (369) |  |  | (971) |
| Proceeds from sales of premises and equipment |  |  | 123 |  |  | — |
| Payment for branch sale, net |  |  | — |  |  | (6,700) |
| Proceeds from sales of other real estate and repossessed assets |  |  | — |  |  | 248 |
| **Net cash used in investing activities** |  |  | (34,296) |  |  | (14,543) |
| **Cash flows from financing activities:** |  |  |  |  |  |  |
| Net increase in demand deposits |  |  | 11,412 |  |  | 9,723 |
| Net (decrease) increase in interest-bearing transaction accounts |  |  | (18,037) |  |  | 12,066 |
| Net (decrease) increase in time deposits |  |  | (325) |  |  | 40,944 |
| Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase |  |  | 3,492 |  |  | (2,550) |
| Repayment of FHLB advances and other borrowings |  |  | (58) |  |  | (57) |
| FHLB advances |  |  | 37,000 |  |  | — |
| Purchase of treasury stock |  |  | (719) |  |  | — |
| Cash dividends paid - common stock |  |  | (753) |  |  | (603) |
| **Net cash provided by financing activities** |  |  | 32,012 |  |  | 59,523 |
| Net (decrease) increase in cash and cash equivalents |  |  | (2,826) |  |  | 48,631 |
| Cash and cash equivalents, beginning of year |  |  | 78,121 |  |  | 42,083 |
| **Cash and cash equivalents, end of year** |  | $ | 75,295 |  | $ | 90,714 |
| **Supplemental disclosures of cash flow information:** |  |  |  |  |  |  |
| Cash paid during the year for: |  |  |  |  |  |  |
| Interest |  | $ | 3,639 |  | $ | 4,228 |
| Income taxes |  | $ | — |  | $ | — |
| **Noncash investing and financing activities:** |  |  |  |  |  |  |
| Other real estate and repossessed assets acquired in settlement of loans |  | $ | — |  | $ | 116 |
| 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 |  | $ | — |  | $ | 2,369 |

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, St. Louis, 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, 2019.

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. These estimates and assumptions are subject to many risks and uncertainties, including changes in interest rates and other general economic, business and political conditions, including the effects of the Coronavirus Disease 2019 (“COVID-19”) pandemic, including its potential effects on the economic environment, our customers and our operations, as well as any changes to federal, state and local government laws, regulations and orders in connection with the pandemic. Actual results could differ from those estimates. The Company’s management has evaluated and did not identify any subsequent events or transactions requiring recognition or disclosure in the consolidated financial statements.

***Stock Dividend*** On July 1, 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.

**The following represents significant new accounting principles adopted in 2020:**

***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. The ASU did not have a material 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

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**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

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 ASU did not have a material impact 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 March 31, 2020 and December 31, 2019 is as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| Commercial, financial, and agricultural |  | $ | 205,657 |  | $ | 199,022 |
| Real estate construction - residential |  |  | 23,913 |  |  | 23,035 |
| Real estate construction - commercial |  |  | 87,497 |  |  | 84,998 |
| Real estate mortgage - residential |  |  | 246,859 |  |  | 252,643 |
| Real estate mortgage - commercial |  |  | 585,900 |  |  | 576,635 |
| Installment and other consumer |  |  | 30,696 |  |  | 32,464 |
| **Total loans held for investment** |  | $ | 1,180,522 |  | $ | 1,168,797 |

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, St. Louis, and the greater Kansas City metropolitan area. As such, the Bank is susceptible to changes in the economic environment in these communities. The Bank does not have a concentration of credit in any one economic sector. Installment and other consumer loans consist primarily of the financing of automotive vehicles. At March 31, 2020, loans of $510.3 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 March 31, 2020** | | | | | | | | | | | | | | | | | | | | | | |
|  |  | **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** |  | **$** | **2,918** |  | **$** | **64** |  | **$** | **369** |  | **$** | **2,118** |  | **$** | **6,547** |  | **$** | **381** |  | **$** | **80** |  | **$** | **12,477** |
| Additions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Provision for loan losses |  |  | 721 |  |  | 53 |  |  | 253 |  |  | 255 |  |  | 2,087 |  |  | 8 |  |  | (77) |  |  | 3,300 |
| Deductions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Loans charged off |  |  | 41 |  |  | — |  |  | — |  |  | 19 |  |  | 22 |  |  | 52 |  |  | — |  |  | 134 |
| Less recoveries on loans |  |  | (25) |  |  | — |  |  | — |  |  | (9) |  |  | (2) |  |  | (14) |  |  | — |  |  | (50) |
| **Net loan charge-offs (recoveries)** |  |  | 16 |  |  | — |  |  | — |  |  | 10 |  |  | 20 |  |  | 38 |  |  | — |  |  | 84 |
| **Balance at end of period** |  | **$** | **3,623** |  | **$** | **117** |  | **$** | **622** |  | **$** | **2,363** |  | **$** | **8,614** |  | **$** | **351** |  | **$** | **3** |  | **$** | **15,693** |

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**HAWTHORN BANCSHARES, INC.**

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|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31, 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 |  |  | (60) |  |  | (66) |  |  | (119) |  |  | (196) |  |  | 617 |  |  | 18 |  |  | (44) |  |  | 150 |
| Deductions: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Loans charged off |  |  | 53 |  |  | — |  |  | — |  |  | 84 |  |  | 8 |  |  | 52 |  |  | — |  |  | 197 |
| Less recoveries on loans |  |  | (108) |  |  | — |  |  | — |  |  | (99) |  |  | — |  |  | (33) |  |  | — |  |  | (240) |
| **Net loan charge-offs (recoveries)** |  |  | (55) |  |  | — |  |  | — |  |  | (15) |  |  | 8 |  |  | 19 |  |  | — |  |  | (43) |
| **Balance at end of period** |  | **$** | **3,232** |  | **$** | **74** |  | **$** | **638** |  | **$** | **1,890** |  | **$** | **5,523** |  | **$** | **333** |  | **$** | **155** |  | **$** | **11,845** |

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.

In the first quarter of 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. At that time, Management determined that with the extended economic recovery then existing, the look-back period should be expanded to include the current economic cycle. The look-back period will be adjusted once a sustained 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. The look-back period is consistently evaluated for relevance given the current facts and circumstances.

As a result of rapidly increasing unemployment rates resulting from the COVID-19 virus, management determined that the first quarter 2020 allowance for loan loss economic qualitative adjustment should be temporarily adapted to utilize currently published statistics rather than the lagging statistics that had been utilized historically. While these lagging indicators have been very reliable for some time, they do not accurately capture the risk that has been brought about by rapid changes in the economy. Based upon the change in the national unemployment rate available as of March 31, 2020, the economic qualitative adjustment was increased according to the Company’s methodology to account for uncertainty in economic conditions compared to the lookback period. Management believes this temporary alteration will be a better indicator until the economy stabilizes and the true impact can be measured.

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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** | |
| **March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Allowance for loan losses:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Individually evaluated for impairment |  | $ | 290 |  | $ | — |  | $ | — |  | $ | 242 |  | $ | 24 |  | $ | 14 |  | $ | — |  | $ | 570 |
| Collectively evaluated for impairment |  |  | 3,333 |  |  | 117 |  |  | 622 |  |  | 2,121 |  |  | 8,590 |  |  | 337 |  |  | 3 |  |  | 15,123 |
| **Total** |  | $ | 3,623 |  | $ | 117 |  | $ | 622 |  | $ | 2,363 |  | $ | 8,614 |  | $ | 351 |  | $ | 3 |  | $ | 15,693 |
| **Loans outstanding:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Individually evaluated for impairment |  | $ | 3,632 |  | $ | — |  | $ | 408 |  | $ | 4,764 |  | $ | 1,418 |  | $ | 135 |  | $ | — |  | $ | 10,357 |
| Collectively evaluated for impairment |  |  | 202,025 |  |  | 23,913 |  |  | 87,089 |  |  | 242,095 |  |  | 584,482 |  |  | 30,561 |  |  | — |  |  | 1,170,165 |
| **Total** |  | $ | 205,657 |  | $ | 23,913 |  | $ | 87,497 |  | $ | 246,859 |  | $ | 585,900 |  | $ | 30,696 |  | $ | — |  | $ | 1,180,522 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **December 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Allowance for loan losses:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Individually evaluated for impairment |  | $ | 311 |  | $ | — |  | $ | — |  | $ | 264 |  | $ | 23 |  | $ | 17 |  | $ | — |  | $ | 615 |
| Collectively evaluated for impairment |  |  | 2,607 |  |  | 64 |  |  | 369 |  |  | 1,854 |  |  | 6,524 |  |  | 364 |  |  | 80 |  |  | 11,862 |
| **Total** |  | $ | 2,918 |  | $ | 64 |  | $ | 369 |  | $ | 2,118 |  | $ | 6,547 |  | $ | 381 |  | $ | 80 |  | $ | 12,477 |
| **Loans outstanding:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Individually evaluated for impairment |  | $ | 1,514 |  | $ | — |  | $ | 137 |  | $ | 3,856 |  | $ | 1,711 |  | $ | 177 |  | $ | — |  | $ | 7,395 |
| Collectively evaluated for impairment |  |  | 197,508 |  |  | 23,035 |  |  | 84,861 |  |  | 248,787 |  |  | 574,924 |  |  | 32,287 |  |  | — |  |  | 1,161,402 |
| **Total** |  | $ | 199,022 |  | $ | 23,035 |  | $ | 84,998 |  | $ | 252,643 |  | $ | 576,635 |  | $ | 32,464 |  | $ | — |  | $ | 1,168,797 |

*Impaired Loans*

Loans evaluated under ASC 310‑10‑35 include loans which are individually evaluated for impairment. All other loans are collectively evaluated for impairment under ASC 450‑20. Impaired loans individually evaluated for impairment totaled $10.4 million and $7.4 million at March 31, 2020 and December 31, 2019, 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 March 31, 2020, $5.8 million of impaired loans were evaluated based on the fair value less estimated selling costs of the loans' collateral compared to $3.0 million at December 31, 2019. Once the impairment amount is calculated, a specific reserve allocation is recorded. At March 31, 2020, $570,000 of the Company’s allowance for loan losses was allocated to impaired loans totaling $10.4 million compared to $615,000 of the Company’s allowance for loan losses allocated to impaired loans totaling approximately $7.4 million at December 31, 2019. Management determined that $5.4 million, or 53%, of total impaired loans required no reserve allocation at March 31, 2020 compared to $2.6 million, or 35%, at December 31, 2019, primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

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The categories of impaired loans at March 31, 2020 and December 31, 2019 are as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| Non-accrual and non-performing TDRs |  | $ | 7,844 |  | $ | 4,860 |
| Performing TDRs |  |  | 2,513 |  |  | 2,535 |
| **Total impaired loans** |  | $ | 10,357 |  | $ | 7,395 |

The following tables provide additional information about impaired loans at March 31, 2020 and December 31, 2019, 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** | |
| **March 31, 2020** |  |  |  |  |  |  |  |  |  |
| **With no related allowance recorded:** |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 2,368 |  | $ | 2,522 |  | $ | — |
| Real estate - construction commercial |  |  | 408 |  |  | 446 |  |  | — |
| Real estate - residential |  |  | 1,556 |  |  | 1,651 |  |  | — |
| Real estate - commercial |  |  | 1,095 |  |  | 1,151 |  |  | — |
| Installment and other consumer |  |  | 12 |  |  | 12 |  |  | — |
| **Total** |  | $ | 5,439 |  | $ | 5,782 |  | $ | — |
| **With an allowance recorded:** |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 1,264 |  | $ | 1,571 |  | $ | 290 |
| Real estate - residential |  |  | 3,208 |  |  | 3,566 |  |  | 242 |
| Real estate - commercial |  |  | 323 |  |  | 431 |  |  | 24 |
| Installment and other consumer |  |  | 123 |  |  | 144 |  |  | 14 |
| **Total** |  | $ | 4,918 |  | $ | 5,712 |  | $ | 570 |
| **Total impaired loans** |  | $ | 10,357 |  | $ | 11,494 |  | $ | 570 |

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|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **Unpaid** | |  |  |  |
|  |  | **Recorded** | |  | **Principal** | |  | **Specific** | |
| *(in thousands)* |  | **Investment** | |  | **Balance** | |  | **Reserves** | |
| **December 31, 2019** |  |  |  |  |  |  |  |  |  |
| **With no related allowance recorded:** |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 342 |  | $ | 487 |  | $ | — |
| Real estate - construction commercial |  |  | 137 |  |  | 173 |  |  | — |
| Real estate - residential |  |  | 697 |  |  | 784 |  |  | — |
| Real estate - commercial |  |  | 1,388 |  |  | 1,433 |  |  | — |
| Installment and other consumer |  |  | 12 |  |  | 12 |  |  | — |
| **Total** |  | $ | 2,576 |  | $ | 2,889 |  | $ | — |
| **With an allowance recorded:** |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 1,172 |  | $ | 1,470 |  | $ | 311 |
| Real estate - residential |  |  | 3,159 |  |  | 3,482 |  |  | 264 |
| Real estate - commercial |  |  | 323 |  |  | 425 |  |  | 23 |
| Installment and other consumer |  |  | 165 |  |  | 189 |  |  | 17 |
| **Total** |  | $ | 4,819 |  | $ | 5,566 |  | $ | 615 |
| **Total impaired loans** |  | $ | 7,395 |  | $ | 8,455 |  | $ | 615 |

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 March 31,** | | | | | | | | | | |
|  |  | **2020** | | | | |  | **2019** | | | | |
|  |  |  |  |  | **Interest** | |  |  |  |  | **Interest** | |
|  |  | **Average** | |  | **Recognized** | |  | **Average** | |  | **Recognized** | |
|  |  | **Recorded** | |  | **For the** | |  | **Recorded** | |  | **For the** | |
| *(in thousands)* |  | **Investment** | |  | **Period Ended** | |  | **Investment** | |  | **Period Ended** | |
| **With no related allowance recorded:** |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 1,097 |  | $ | — |  | $ | 1,330 |  | $ | — |
| Real estate - construction commercial |  |  | 209 |  |  | — |  |  | 158 |  |  | — |
| Real estate - residential |  |  | 898 |  |  | — |  |  | 850 |  |  | — |
| Real estate - commercial |  |  | 1,178 |  |  | 6 |  |  | 170 |  |  | — |
| Installment and other consumer |  |  | 10 |  |  | — |  |  | 34 |  |  | — |
| **Total** |  | $ | 3,392 |  | $ | 6 |  | $ | 2,542 |  | $ | — |
| **With an allowance recorded:** |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | $ | 1,120 |  | $ | 8 |  | $ | 1,276 |  | $ | 11 |
| Real estate - residential |  |  | 3,348 |  |  | 20 |  |  | 4,160 |  |  | 25 |
| Real estate - commercial |  |  | 352 |  |  | 2 |  |  | 946 |  |  | 9 |
| Installment and other consumer |  |  | 164 |  |  | 6 |  |  | 232 |  |  | 1 |
| **Total** |  | $ | 4,984 |  | $ | 36 |  | $ | 6,614 |  | $ | 46 |
| **Total impaired loans** |  | $ | 8,376 |  | $ | 42 |  | $ | 9,156 |  | $ | 46 |

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 $42,000 for the three months ended March 31, 2020 compared to $46,000 for the three months ended March 31, 2019. The average recorded investment in impaired loans is calculated on a monthly basis during the periods reported.

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*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 March 31, 2020 and December 31, 2019.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **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** | |
| **March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, Financial, and Agricultural |  | $ | 201,949 |  | $ | 597 |  | $ | — |  | $ | 3,111 |  | $ | 205,657 |
| Real Estate Construction - Residential |  |  | 23,620 |  |  | 293 |  |  | — |  |  | — |  |  | 23,913 |
| Real Estate Construction - Commercial |  |  | 86,511 |  |  | 578 |  |  | — |  |  | 408 |  |  | 87,497 |
| Real Estate Mortgage - Residential |  |  | 241,673 |  |  | 1,785 |  |  | 190 |  |  | 3,211 |  |  | 246,859 |
| Real Estate Mortgage - Commercial |  |  | 584,029 |  |  | 803 |  |  | — |  |  | 1,068 |  |  | 585,900 |
| Installment and Other Consumer |  |  | 30,447 |  |  | 176 |  |  | 27 |  |  | 46 |  |  | 30,696 |
| **Total** |  | $ | 1,168,229 |  | $ | 4,232 |  | $ | 217 |  | $ | 7,844 |  | $ | 1,180,522 |
| **December 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, Financial, and Agricultural |  | $ | 197,828 |  | $ | 212 |  | $ | — |  | $ | 982 |  | $ | 199,022 |
| Real Estate Construction - Residential |  |  | 22,468 |  |  | 567 |  |  | — |  |  | — |  |  | 23,035 |
| Real Estate Construction - Commercial |  |  | 84,861 |  |  | — |  |  | — |  |  | 137 |  |  | 84,998 |
| Real Estate Mortgage - Residential |  |  | 249,516 |  |  | 688 |  |  | 304 |  |  | 2,135 |  |  | 252,643 |
| Real Estate Mortgage - Commercial |  |  | 575,140 |  |  | 136 |  |  | — |  |  | 1,359 |  |  | 576,635 |
| Installment and Other Consumer |  |  | 32,179 |  |  | 132 |  |  | 12 |  |  | 141 |  |  | 32,464 |
| **Total** |  | $ | 1,161,992 |  | $ | 1,735 |  | $ | 316 |  | $ | 4,754 |  | $ | 1,168,797 |

*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

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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 March 31, 2020 and December 31, 2019.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **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 March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Watch |  | $ | 16,305 |  | $ | 601 |  | $ | 7,682 |  | $ | 14,902 |  | $ | 37,184 |  | $ | — |  | $ | 76,674 |
| Substandard |  |  | 1,258 |  |  | — |  |  | — |  |  | 1,499 |  |  | 511 |  |  | — |  |  | 3,268 |
| Performing TDRs |  |  | 521 |  |  | — |  |  | — |  |  | 1,554 |  |  | 350 |  |  | 88 |  |  | 2,513 |
| Non-accrual and non-performing TDRs |  |  | 3,111 |  |  | — |  |  | 408 |  |  | 3,211 |  |  | 1,068 |  |  | 46 |  |  | 7,844 |
| **Total** |  | $ | 21,195 |  | $ | 601 |  | $ | 8,090 |  | $ | 21,166 |  | $ | 39,113 |  | $ | 134 |  | $ | 90,299 |
| **At December 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Watch |  | $ | 16,288 |  | $ | 763 |  | $ | 8,484 |  | $ | 15,280 |  | $ | 37,271 |  | $ | — |  | $ | 78,086 |
| Substandard |  |  | 3,249 |  |  | — |  |  | 273 |  |  | 2,291 |  |  | 677 |  |  | — |  |  | 6,490 |
| Performing TDRs |  |  | 532 |  |  | — |  |  | — |  |  | 1,615 |  |  | 352 |  |  | 36 |  |  | 2,535 |
| Non-accrual and non-performing TDRs |  |  | 982 |  |  | — |  |  | 137 |  |  | 2,241 |  |  | 1,359 |  |  | 141 |  |  | 4,860 |
| **Total** |  | $ | 21,051 |  | $ | 763 |  | $ | 8,894 |  | $ | 21,427 |  | $ | 39,659 |  | $ | 177 |  | $ | 91,971 |

*Troubled Debt Restructurings*

At March 31, 2020, loans classified as TDRs totaled $3.7 million, of which $1.2 million were classified as non-performing TDRs and $2.5 million were classified as performing TDRs. At December 31, 2019, loans classified as TDRs totaled $4.1 million, of which $1.6 million were classified as non-performing TDRs and $2.5 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 $375,000 and $442,000 related to TDRs were allocated to the allowance for loan losses at March 31, 2020 and December 31, 2019, respectively.

The CARES Act provides all banks with the option to elect either or both of the following from March 1, 2020 until the earlier of December 31, 2020 or the date that is 60 days after the termination of the national emergency:

(i) to suspend the requirements under GAAP for loan modifications related to the COVID–19 pandemic that would otherwise be categorized as a TDR; and/or

(ii) to suspend any determination of a loan modified as a result of the effects of the COVID–19 pandemic as being a TDR, including impairment for accounting purposes.

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If a bank elects a suspension noted above, the suspension (i) will be effective for the term of the loan modification, but solely with respect to any modification, including a forbearance arrangement, an interest rate modification, a repayment plan, and any other similar arrangement that defers or delays the payment of principal or interest, that occurs during the applicable period for a loan that was not more than 30 days past due as of December 31, 2019; and (ii) will not apply to any adverse impact on the credit of a borrower that is not related to the COVID–19 pandemic.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | | | | | | | | | | | |
|  |  | **2020** | | | | | | |  | **2019** | | | | | | |
|  |  | **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 |  | $ | 80 |
| Installment and other consumer |  | 1 |  |  | 6 |  |  | 5 |  | — |  |  | — |  |  | — |
| **Total** |  | 1 |  | $ | 6 |  | $ | 5 |  | 2 |  | $ | 80 |  | $ | 80 |

|  |  |  |  |
| --- | --- | --- | --- |
|  | (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 modified as a TDR that defaulted during any of the three months ended March 31, 2020 and 2019, respectively, and within twelve months of their modification date.

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 months ended March 31, 2020 and 2019, respectively, and within twelve months of their modification date.  See *Lending and Credit Management* section for further information.

*Loans Held For Sale*

The Company designates certain long-term fixed rate personal real estate loans as held for sale, and the Company carries them at the lower of cost or fair value. The loans are primarily sold to Freddie Mac, Fannie Mae, and PennyMac. At March 31, 2020, the carrying amount of these loans was $4.3 million.

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| Commercial |  | $ | 1,155 |  | $ | 1,155 |
| Real estate construction - commercial |  |  | 11,553 |  |  | 11,553 |
| Real estate mortgage - residential |  |  | 230 |  |  | 230 |
| Real estate mortgage - commercial |  |  | 2,799 |  |  | 2,799 |
| Total |  | $ | 15,737 |  | $ | 15,737 |
| Less valuation allowance for other real estate owned |  |  | (2,968) |  |  | (2,956) |
| **Total other real estate owned** |  | $ | 12,769 |  | $ | 12,781 |

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | |  |
|  |  | **2020** | |  | **2019** | |  |
| **Balance at beginning of period** |  | $ | 15,737 |  | $ | 16,693 |  |
| Additions |  |  | — |  |  | 116 |  |
| Proceeds from sales |  |  | — |  |  | (248) |  |
| Charge-offs against the valuation allowance for other real estate owned, net |  |  | — |  |  | (38) |  |
| Net gain on sales |  |  | — |  |  | 6 |  |
| Total other real estate owned |  | $ | 15,737 |  | $ | 16,529 |  |
| Less valuation allowance for other real estate owned |  |  | (2,968) |  |  | (2,992) |  |
| **Balance at end of period** |  | $ | 12,769 |  | $ | 13,537 |  |

At March 31, 2020, $275,000 of consumer mortgage loans secured by residential real estate properties were in the process of foreclosure compared to $252,000 of consumer mortgage loans at December 31, 2019.

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| **Balance, beginning of period** |  | $ | 2,956 |  | $ | 3,002 |
| Provision for other real estate owned |  |  | 12 |  |  | 28 |
| Charge-offs |  |  | — |  |  | (38) |
| **Balance, end of period** |  | $ | 2,968 |  | $ | 2,992 |

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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 March 31, 2020 and December 31, 2019 were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Total** | |  |  |  |  |  |  |  |  |  |
|  |  | **Amortized** | |  | **Gross Unrealized** | | | | |  | **Fair** | |
| (*in thousands)* |  | **Cost** | |  | **Gains** | |  | **Losses** | |  | **Value** | |
| **March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 743 |  | $ | 34 |  | $ | — |  | $ | 777 |
| U.S. government and federal agency obligations |  |  | 8,922 |  |  | 43 |  |  | (19) |  |  | 8,946 |
| U.S. government-sponsored enterprises |  |  | 37,320 |  |  | 433 |  |  | — |  |  | 37,753 |
| Obligations of states and political subdivisions |  |  | 42,724 |  |  | 486 |  |  | (53) |  |  | 43,157 |
| Mortgage-backed securities |  |  | 101,123 |  |  | 1,957 |  |  | (63) |  |  | 103,017 |
| Other debt securities (a) |  |  | 3,000 |  |  | 174 |  |  | — |  |  | 3,174 |
| Bank issued trust preferred securities (a) |  |  | 1,486 |  |  | — |  |  | (261) |  |  | 1,225 |
| **Total available-for-sale securities** |  | $ | 195,318 |  | $ | 3,127 |  | $ | (396) |  | $ | 198,049 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| **December 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 987 |  | $ | 8 |  | $ | — |  | $ | 995 |
| U.S. government and federal agency obligations |  |  | 8,124 |  |  | — |  |  | (77) |  |  | 8,047 |
| U.S. government-sponsored enterprises |  |  | 22,300 |  |  | 41 |  |  | (58) |  |  | 22,283 |
| Obligations of states and political subdivisions |  |  | 33,704 |  |  | 144 |  |  | (59) |  |  | 33,789 |
| Mortgage-backed securities |  |  | 105,522 |  |  | 522 |  |  | (428) |  |  | 105,616 |
| Other debt securities (a) |  |  | 3,000 |  |  | 53 |  |  | — |  |  | 3,053 |
| Bank issued trust preferred securities (a) |  |  | 1,486 |  |  | — |  |  | (176) |  |  | 1,310 |
| **Total available-for-sale securities** |  | $ | 175,123 |  | $ | 768 |  | $ | (798) |  | $ | 175,093 |

(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 $149.8 million and $139.8 million at March 31, 2020 and December 31, 2019, 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 March 31, 2020, 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 |  | $ | 8,923 |  | $ | 8,954 |
| Due after one year through five years |  |  | 20,335 |  |  | 20,462 |
| Due after five years through ten years |  |  | 42,787 |  |  | 43,470 |
| Due after ten years |  |  | 22,150 |  |  | 22,146 |
| Total |  |  | 94,195 |  |  | 95,032 |
| Mortgage-backed securities |  |  | 101,123 |  |  | 103,017 |
| **Total available-for-sale securities** |  | $ | 195,318 |  | $ | 198,049 |

*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.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **March 31, 2020** | |  | **December 31, 2019** | |  |
| *(in thousands)* |  | **2020** | |  | **2019** | |  |
| **Other securities:** |  |  |  |  |  |  |  |
| FHLB stock |  | $ | 7,133 |  | $ | 5,644 |  |
| MIB stock |  |  | 151 |  |  | 151 |  |
| Equity securities with readily determinable fair values |  |  | 12 |  |  | 13 |  |
| **Total other investment securities** |  | $ | 7,296 |  | $ | 5,808 |  |

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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 March 31, 2020 and December 31, 2019 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 March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. government and federal agency obligations |  | $ | 1,686 |  | $ | (13) |  | $ | 1,557 |  | $ | (6) |  | $ | 3,243 |  | $ | (19) |
| Obligations of states and political subdivisions |  |  | 7,440 |  |  | (50) |  |  | 532 |  |  | (3) |  |  | 7,972 |  |  | (53) |
| Mortgage-backed securities |  |  | 11,296 |  |  | (55) |  |  | 1,710 |  |  | (8) |  |  | 13,006 |  |  | (63) |
| Bank issued trust preferred securities |  |  | — |  |  | — |  |  | 1,225 |  |  | (261) |  |  | 1,225 |  |  | (261) |
| **Total** |  | $ | 20,422 |  | $ | (118) |  | $ | 5,024 |  | $ | (278) |  | $ | 25,446 |  | $ | (396) |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **At December 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. government and federal agency obligations |  | $ | 6,238 |  | $ | (69) |  | $ | 1,809 |  | $ | (8) |  | $ | 8,047 |  | $ | (77) |
| U.S. government-sponsored enterprises |  |  | 5,949 |  |  | (47) |  |  | 7,488 |  |  | (11) |  |  | 13,437 |  |  | (58) |
| Obligations of states and political subdivisions |  |  | 10,729 |  |  | (53) |  |  | 1,931 |  |  | (6) |  |  | 12,660 |  |  | (59) |
| Mortgage-backed securities |  |  | 5,444 |  |  | (37) |  |  | 40,120 |  |  | (391) |  |  | 45,564 |  |  | (428) |
| Bank issued trust preferred securities |  |  | — |  |  | — |  |  | 1,310 |  |  | (176) |  |  | 1,310 |  |  | (176) |
| **Total** |  | $ | 28,360 |  | $ | (206) |  | $ | 52,658 |  | $ | (592) |  | $ | 81,018 |  | $ | (798) |

The total available for sale portfolio consisted of approximately 321 securities at March 31, 2020. The portfolio included 46 securities having an aggregate fair value of $25.4 million that were in a loss position at March 31, 2020. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled $5.0 million at fair value at March 31, 2020. The $396,000 aggregate unrealized loss included in accumulated other comprehensive loss at March 31, 2020 was caused by interest rate fluctuations.

The total available for sale portfolio consisted of approximately 322 securities at December 31, 2019. The portfolio included 128 securities having an aggregate fair value of $81.0 million that were in a loss position at December 31, 2019. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer had a fair value of $52.7 million at December 31, 2019. The $798,000 aggregate unrealized loss included in accumulated other comprehensive loss at December 31, 2019 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 March 31, 2020 and December 31, 2019, 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 March 31,** | | | | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| ***Investment securities (losses) gains, net*** |  |  |  |  |  |  |
| **Available for sale securities:** |  |  |  |  |  |  |
| Gains realized on sales |  | $ | — |  | $ | — |
| Losses realized on sales |  |  | — |  |  | — |
| Other-than-temporary impairment recognized |  |  | — |  |  | — |
| **Other investment securities:** |  |  |  |  |  |  |
| Fair value adjustments, net |  |  | (1) |  |  | 1 |
| **Investment securities (losses) gains, net** |  | **$** | **(1)** |  | **$** | **1** |

During the three months ended March 31, 2020, the Company received $681,000 from the proceeds from the sale of available for sale debt securities and recognized an immaterial gain. There were no securities sales during the three months ended March 31, 2019. The Company recognized an unrealized loss of $1,000 for the three months ended March 31, 2020, compared to an unrealized gain of $1,000 for the three months ended March 31, 2019 related to equity securities.

**(5)   Intangible Assets**

*Mortgage Servicing Rights*

At March 31, 2020, the Company was servicing approximately $270.6 million of loans sold to the secondary market compared to $271.4 million at December 31, 2019, and $275.7 million at March  31, 2019. Mortgage loan servicing fees, reported in real estate servicing fees, net, earned on loans sold were $188,000 for the three months ended March 31, 2020,   compared to $178,000 for the three months ended March  31, 2019.

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| **Balance at beginning of period** |  | $ | 2,482 |  | $ | 2,931 |
| Originated mortgage servicing rights |  |  | 67 |  |  | 38 |
| Changes in fair value: |  |  |  |  |  |  |
| Due to changes in model inputs and assumptions (1) |  |  | (198) |  |  | (32) |
| Other changes in fair value (2) |  |  | (77) |  |  | (62) |
| Total changes in fair value |  |  | (275) |  |  | (94) |
| **Balance at end of period** |  | $ | 2,274 |  | $ | 2,875 |

(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 March  31, 2020 and 2019, respectively:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
|  | **Three Months Ended March 31,** | | | | |
|  |  | **2020** |  | **2019** |  |
| Weighted average constant prepayment rate |  | 15.18 | % | 9.47 | % |
| Weighted average note rate |  | 3.91 | % | 3.96 | % |
| Weighted average discount rate |  | 8.25 | % | 9.77 | % |
| Weighted average expected life (in years) |  | 4.4 |  | 6.0 |  |

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |  |
| *(in thousands)* |  | **2020** | |  | **2019** | |  |
| Federal funds purchased |  | $ | — |  | $ | — |  |
| Repurchase agreements |  |  | 30,764 |  |  | 27,272 |  |
| Total |  | $ | 30,764 |  | $ | 27,272 |  |

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 March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 779 |  | $ | — |  | $ | — |  | $ | 779 |
| U.S. government-sponsored enterprises |  |  | 17,275 |  |  | — |  |  | — |  |  | 17,275 |
| Asset-backed securities |  |  | 12,710 |  |  | — |  |  | — |  |  | 12,710 |
| **Total** |  | $ | 30,764 |  | $ | — |  | $ | — |  | $ | 30,764 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| **At December 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 754 |  | $ | — |  | $ | — |  | $ | 754 |
| U.S. government-sponsored enterprises |  |  | 12,853 |  |  | — |  |  | — |  |  | 12,853 |
| Asset-backed securities |  |  | 13,665 |  |  | — |  |  | — |  |  | 13,665 |
| **Total** |  | $ | 27,272 |  | $ | — |  | $ | — |  | $ | 27,272 |

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**(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 March 31, 2020, operating ROU assets and liabilities were $2.1 million and $2.2 million, respectively. As of March 31, 2020, the weighted-average remaining lease term on these operating leases is approximately 8.2 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 months ended March 31, 2020 and 2019 was $86,000 and $32,000,  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 $33,000 for the three months ended March 31, 2020 compared to $35,000 for the three months ended March  31,  2019.

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

|  |  |  |  |
| --- | --- | --- | --- |
|  |  |  |  |
|  |  | **Operating** | |
| **Lease payments due in:** |  | **Lease** | |
| *(in thousands)* |  |  |  |
| 2020 (excluding 3 months ending March 31, 2020) |  | $ | 251 |
| 2021 |  |  | 317 |
| 2022 |  |  | 310 |
| 2023 |  |  | 312 |
| 2024 |  |  | 258 |
| Thereafter |  |  | 1,087 |
| Total lease payments |  |  | 2,535 |
| Less imputed interest |  |  | (373) |
| Total lease liabilities, as reported |  | $ | 2,162 |
|  |  |  |  |

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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 15.3% for the three months ended March 31, 2020 compared to 18.9%  for the three months ended March  31, 2019. The decrease in the effective tax rate was primarily attributable to the impact of tax-free revenues having a greater impact to pre-tax income due to the reduced level of earnings this quarter

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 March 31, 2020.  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 months ended March 31, 2020 and 2019, respectively, the Company did not have any uncertain tax provisions, and did not record any related tax liabilities.

**(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 three months ended March 31, 2020 and 2019:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31, 2020** | | | | | | | |
|  |  |  |  |  |  |  |  | **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** |  | $ | (23) |  | $ | (3,732) |  | $ | (3,755) |
| Other comprehensive income, before reclassifications |  |  | 2,760 |  |  | 67 |  |  | 2,827 |
| Amounts reclassified from accumulated other comprehensive (loss) income |  |  | — |  |  | — |  |  | — |
| Current period other comprehensive income, before tax |  |  | 2,760 |  |  | 67 |  |  | 2,827 |
| Income tax expense |  |  | (580) |  |  | (14) |  |  | (594) |
| Current period other comprehensive income, net of tax |  |  | 2,180 |  |  | 53 |  |  | 2,233 |
| **Balance at end of period** |  | $ | 2,157 |  | $ | (3,679) |  | $ | (1,522) |

|  |
| --- |
|  |

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|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31, 2019** | | | | | | | |
|  |  |  |  |  | **Unrecognized Net** | |  | **Accumulated** | |
|  |  | **Unrealized** | |  | **Pension and** | |  | **Other** | |
|  |  | **Gain (Loss)** | |  | **Postretirement** | |  | **Comprehensive** | |
| *(in thousands)* |  | **on Securities (1)** | |  | **Costs (2)** | |  | **Loss** | |
| **Balance at beginning of period** |  | $ | (3,455) |  | $ | (2,644) |  | $ | (6,099) |
| Other comprehensive income, before reclassifications |  |  | 1,745 |  |  | 19 |  |  | 1,764 |
| Amounts reclassified from accumulated other comprehensive income |  |  | — |  |  | — |  |  | — |
| Current period other comprehensive income, before tax |  |  | 1,745 |  |  | 19 |  |  | 1,764 |
| Income tax benefit |  |  | (367) |  |  | (4) |  |  | (371) |
| Current period other comprehensive income, net of tax |  |  | 1,378 |  |  | 15 |  |  | 1,393 |
| **Balance at end of period** |  | $ | (2,077) |  | $ | (2,629) |  | $ | (4,706) |

|  |  |  |  |
| --- | --- | --- | --- |
|  | (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. |

**(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 March 31,** | | | | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| Payroll taxes |  | $ | 389 |  | $ | 346 |
| Medical plans |  |  | 427 |  |  | 450 |
| 401(k) match and profit sharing |  |  | 306 |  |  | 276 |
| Periodic pension cost |  |  | 464 |  |  | 379 |
| Other |  |  | 23 |  |  | 15 |
| **Total employee benefits** |  | $ | 1,609 |  | $ | 1,466 |

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 March 31, 2020, the accrued liability was $720,000 and the expense for both the three months ended March 31, 2020 and 2019 was $80,000 and is recognized over the required service period.

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*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 $500,000 on March 25, 2020. 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.

*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)* |  | **2020** | |  | **2019** | |  |
| Service cost - benefits earned during the year |  | $ | 1,857 |  | $ | 1,516 |  |
| Interest costs on projected benefit obligations (a) |  |  | 1,159 |  |  | 1,168 |  |
| Expected return on plan assets (a) |  |  | (1,572) |  |  | (1,393) |  |
| Expected administrative expenses (a) |  |  | 110 |  |  | 100 |  |
| Amortization of prior service cost (a) |  |  | 50 |  |  | 79 |  |
| Amortization of unrecognized net loss (a) |  |  | 218 |  |  | — |  |
| **Net periodic pension cost** |  | $ | 1,822 |  | $ | 1,470 |  |
|  |  |  |  |  |  |  |  |
| Net periodic pension cost for the three months ended March 31, (actual) |  | $ | 464 |  | $ | 379 |  |

|  |  |  |  |
| --- | --- | --- | --- |
|  | (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

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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.

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 March 31,** | | | | |
| *(dollars in thousands, except per share data)* |  | **2020** | |  | **2019** | |
| **Basic earnings per share:** |  |  |  |  |  |  |
| Net income available to shareholders |  | $ | 868 |  | $ | 4,666 |
| Average shares outstanding |  |  | 6,260,741 |  |  | 6,276,236 |
| **Basic earnings per share** |  | $ | 0.14 |  | $ | 0.74 |
| **Diluted earnings per share:** |  |  |  |  |  |  |
| Net income available to shareholders |  | $ | 868 |  | $ | 4,666 |
| Average shares outstanding |  |  | 6,260,741 |  |  | 6,276,236 |
| Effect of dilutive stock options |  |  | — |  |  | — |
| Average shares outstanding including dilutive stock options |  |  | 6,260,741 |  |  | 6,276,236 |
| **Diluted earnings per share** |  | $ | 0.14 |  |  | 0.74 |

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 shares for the three months ended March 31, 2020 that were omitted from the computation of diluted earnings per share as a result of being considered anti-dilutive.

***Repurchase Program*** 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. As of March 31, 2020, the Company had repurchased a total of 34,934 shares of common stock pursuant to the plan at an average price of $20.59 per share.

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**(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.

The fair value hierarchy is as follows:

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

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

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

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

***Valuation Methods for Assets and 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.

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***Mortgage Servicing Rights***

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **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)** | |
| **March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 777 |  | $ | 777 |  |  | — |  | $ | — |
| U.S. government and federal agency obligations |  |  | 8,946 |  |  | — |  |  | 8,946 |  |  | — |
| U.S. government-sponsored enterprises |  |  | 37,753 |  |  | — |  |  | 37,753 |  |  | — |
| Obligations of states and political subdivisions |  |  | 43,157 |  |  | — |  |  | 43,157 |  |  | — |
| Mortgage-backed securities |  |  | 103,017 |  |  | — |  |  | 103,017 |  |  | — |
| Other debt securities |  |  | 3,174 |  |  | — |  |  | 3,174 |  |  | — |
| Bank-issued trust preferred securities |  |  | 1,225 |  |  | — |  |  | 1,225 |  |  | — |
| Equity securities |  |  | 12 |  |  | 12 |  |  | — |  |  | — |
| Mortgage servicing rights |  |  | 2,274 |  |  | — |  |  | — |  |  | 2,274 |
| **Total** |  | $ | 200,335 |  | $ | 789 |  | $ | 197,272 |  | $ | 2,274 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| **December 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 995 |  | $ | 995 |  |  | — |  | $ | — |
| U.S. government and federal agency obligations |  |  | 8,047 |  |  | — |  |  | 8,047 |  |  | — |
| U.S. government-sponsored enterprises |  |  | 22,283 |  |  | — |  |  | 22,283 |  |  | — |
| Obligations of states and political subdivisions |  |  | 33,789 |  |  | — |  |  | 33,789 |  |  | — |
| Mortgage-backed securities |  |  | 105,616 |  |  | — |  |  | 105,616 |  |  | — |
| Other debt securities |  |  | 3,053 |  |  | — |  |  | 3,053 |  |  | — |
| Bank-issued trust preferred securities |  |  | 1,310 |  |  | — |  |  | 1,310 |  |  | — |
| Equity securities |  |  | 13 |  |  | 13 |  |  | — |  |  | — |
| Mortgage servicing rights |  |  | 2,482 |  |  | — |  |  | — |  |  | 2,482 |
| **Total** |  | $ | 177,588 |  | $ | 1,008 |  | $ | 174,098 |  | $ | 2,482 |

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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** | | | | |
|  |  | **(Level 3)** | | | | |
|  |  | **Mortgage Servicing Rights** | | | | |
|  |  | **Three Months Ended March 31,** | | | | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| Balance at beginning of period |  | $ | 2,482 |  | $ | 2,931 |
| Total (losses) or gains (realized/unrealized): |  |  |  |  |  |  |
| Included in earnings |  |  | (275) |  |  | (94) |
| Included in other comprehensive income |  |  | — |  |  | — |
| Purchases |  |  | — |  |  | — |
| Sales |  |  | — |  |  | — |
| Issues |  |  | 67 |  |  | 38 |
| Settlements |  |  | — |  |  | — |
| Balance at end of period |  | $ | 2,274 |  | $ | 2,875 |

***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 March 31, 2020, the Company identified $5.8 million in collateral dependent impaired loans that had specific allowances for losses aggregating $257,000. Related to these loans, there were $55,000 in charge-offs recorded during the three months ended March 31, 2020. As of March  31, 2019, the Company identified $3.8 million in collateral dependent impaired loans that had specific allowances for losses aggregating $702,000. Related to these loans, there were no charge-offs recorded during the three months ended March  31, 2019.

*Other Real Estate and Foreclosed Assets*

Other real estate owned (OREO) and foreclosed assets consisted of loan collateral that has been repossessed through foreclosure. This collateral is comprised of commercial and residential real estate and other non-real estate property, including autos, manufactured homes, and construction equipment. Subsequent to foreclosure, these assets initially are carried at fair value of the collateral less estimated selling costs. Fair value, when recorded, is generally based

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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** | |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **Markets for** | |  | **Other** | |  | **Significant** | |  |  |  |
|  |  |  |  |  | **Identical** | |  | **Observable** | |  | **Unobservable** | |  |  |  |
|  |  | **Total** | |  | **Assets** | |  | **Inputs** | |  | **Inputs** | |  | **Total Gains** | |
| *(in thousands)* |  | **Fair Value** | |  | **(Level 1)** | |  | **(Level 2)** | |  | **(Level 3)** | |  | **(Losses)\*** | |
| **March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Collateral dependent impaired loans: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, & agricultural |  | $ | 2,422 |  | $ | — |  | $ | — |  | $ | 2,422 |  | $ | — |
| Real estate construction - commercial |  |  | 408 |  |  | — |  |  | — |  |  | 408 |  |  | — |
| Real estate mortgage - residential |  |  | 1,921 |  |  | — |  |  | — |  |  | 1,921 |  |  | (19) |
| Real estate mortgage - commercial |  |  | 827 |  |  | — |  |  | — |  |  | 827 |  |  | (22) |
| Installment and other consumer |  |  | 12 |  |  | — |  |  | — |  |  | 12 |  |  | (14) |
| Total |  | $ | 5,590 |  | $ | — |  | $ | — |  | $ | 5,590 |  | $ | (55) |
| Other real estate and repossessed assets |  | $ | 12,769 |  | $ | — |  | $ | — |  | $ | 12,769 |  | $ | (12) |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **March 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Collateral dependent impaired loans: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, & agricultural |  | $ | 1,263 |  | $ | — |  | $ | — |  | $ | 1,263 |  | $ | — |
| Real estate construction - commercial |  |  | 151 |  |  | — |  |  | — |  |  | 151 |  |  | — |
| Real estate mortgage - residential |  |  | 1,480 |  |  | — |  |  | — |  |  | 1,480 |  |  | — |
| Real estate mortgage - commercial |  |  | 233 |  |  | — |  |  | — |  |  | 233 |  |  | — |
| Total |  | $ | 3,127 |  | $ | — |  | $ | — |  | $ | 3,127 |  | $ | — |
| Other real estate and repossessed assets |  | $ | 13,537 |  | $ | — |  | $ | — |  | $ | 13,537 |  | $ | (106) |

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

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

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

***Loans***

Fair values are estimated for portfolios with similar financial characteristics. Loans are segregated by type, such as commercial, real estate, and consumer. Each loan category is further segmented into fixed and variable interest rate categories. The fair value of loans, 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

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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.

***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

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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.

***Operating Lease Liabilities***

The fair value of 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.

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A summary of the carrying amounts and fair values of the Company’s financial instruments at March 31, 2020 and December 31, 2019 is as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **March 31, 2020** | | | | | | | |
|  |  |  |  |  |  |  |  | **Fair Value Measurements** | | | | | | | |
|  |  |  |  |  |  |  |  |  | **Quoted Prices** |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **in Active** | |  |  |  |  | **Net** | |
|  |  |  |  |  |  |  |  | **Markets for** | |  | **Other** | |  | **Significant** | |
|  |  | **March 31, 2020** | | | | |  | **Identical** | |  | **Observable** | |  | **Unobservable** | |
|  |  | **Carrying** | |  | **Fair** | |  | **Assets** | |  | **Inputs** | |  | **Inputs** | |
| *(in thousands)* |  | **amount** | |  | **value** | |  | **(Level 1)** | |  | **(Level 2)** | |  | **(Level 3)** | |
| **Assets:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Cash and due from banks |  | $ | 16,676 |  | $ | 16,676 |  | $ | 16,676 |  | $ | — |  | $ | — |
| Federal funds sold and overnight interest-bearing deposits |  |  | 58,619 |  |  | 58,619 |  |  | 58,619 |  |  | — |  |  | — |
| Certificates of deposit in other banks |  |  | 11,106 |  |  | 11,106 |  |  | 11,106 |  |  | — |  |  | — |
| Available for sale securities |  |  | 198,049 |  |  | 198,049 |  |  | 777 |  |  | 197,272 |  |  | — |
| Other investment securities |  |  | 7,296 |  |  | 7,296 |  |  | 12 |  |  | 7,284 |  |  | — |
| Loans, net |  |  | 1,164,829 |  |  | 1,180,815 |  |  | — |  |  | — |  |  | 1,180,815 |
| Loans held for sale |  |  | 4,286 |  |  | 4,322 |  |  | — |  |  | — |  |  | 4,322 |
| Cash surrender value - life insurance |  |  | 2,411 |  |  | 2,411 |  |  | — |  |  | 2,411 |  |  | — |
| Accrued interest receivable |  |  | 6,263 |  |  | 6,263 |  |  | 6,263 |  |  | — |  |  | — |
| Total |  | $ | 1,469,535 |  | $ | 1,485,557 |  | $ | 93,453 |  | $ | 206,967 |  | $ | 1,185,137 |
| **Liabilities:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Deposits: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Non-interest bearing demand |  | $ | 272,578 |  | $ | 272,578 |  | $ | 272,578 |  | $ | — |  | $ | — |
| Savings, interest checking and money market |  |  | 596,294 |  |  | 596,294 |  |  | 596,294 |  |  | — |  |  | — |
| Time deposits |  |  | 310,699 |  |  | 313,690 |  |  | — |  |  | — |  |  | 313,690 |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 30,764 |  |  | 30,764 |  |  | 30,764 |  |  | — |  |  | — |
| Federal Home Loan Bank advances and other borrowings |  |  | 133,861 |  |  | 136,395 |  |  | — |  |  | 136,395 |  |  | — |
| Subordinated notes |  |  | 49,486 |  |  | 40,800 |  |  | — |  |  | 40,800 |  |  | — |
| Operating lease liabilities |  |  | 2,162 |  |  | 2,162 |  |  |  |  |  | 2,162 |  |  |  |
| Accrued interest payable |  |  | 780 |  |  | 780 |  |  | 780 |  |  | — |  |  | — |
| Total |  | $ | 1,396,624 |  | $ | 1,393,463 |  | $ | 900,416 |  | $ | 179,357 |  | $ | 313,690 |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **December 31, 2019** | | | | | | | |
|  |  |  |  |  |  |  |  | **Fair Value Measurements** | | | | | | | |
|  |  |  |  |  |  |  |  | **Quoted Prices** | |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **in Active** | |  |  |  |  | **Net** | |
|  |  |  |  |  |  |  |  | **Markets for** | |  | **Other** | |  | **Significant** | |
|  |  | **December 31, 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 |  | $ | 22,576 |  | $ | 22,576 |  | $ | 22,576 |  | $ | — |  | $ | — |
| Federal funds sold and overnight interest-bearing deposits |  |  | 55,545 |  |  | 55,545 |  |  | 55,545 |  |  | — |  |  | — |
| Certificates of deposit in other banks |  |  | 10,862 |  |  | 10,862 |  |  | 10,862 |  |  | — |  |  | — |
| Available-for-sale securities |  |  | 175,093 |  |  | 175,093 |  |  | 995 |  |  | 174,098 |  |  | — |
| Other investment securities |  |  | 5,808 |  |  | 5,808 |  |  | 13 |  |  | 5,795 |  |  | — |
| Loans, net |  |  | 1,156,320 |  |  | 1,148,339 |  |  | — |  |  | — |  |  | 1,148,339 |
| Loans held for sale |  |  | 428 |  |  | 435 |  |  | — |  |  | — |  |  | 435 |
| Cash surrender value - life insurance |  |  | 2,398 |  |  | 2,398 |  |  | — |  |  | 2,398 |  |  | — |
| Accrued interest receivable |  |  | 6,481 |  |  | 6,481 |  |  | 6,481 |  |  | — |  |  | — |
|  |  | $ | 1,435,511 |  | $ | 1,427,537 |  | $ | 96,472 |  | $ | 182,291 |  | $ | 1,148,774 |
| **Liabilities:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Deposits: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Non-interest bearing demand |  | $ | 261,166 |  | $ | 261,166 |  | $ | 261,166 |  | $ | — |  | $ | — |
| Savings, interest checking and money market |  |  | 614,331 |  |  | 614,331 |  |  | 614,331 |  |  | — |  |  | — |
| Time deposits |  |  | 311,024 |  |  | 311,489 |  |  | — |  |  | — |  |  | 311,489 |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 27,272 |  |  | 27,272 |  |  | 27,272 |  |  | — |  |  | — |
| Federal Home Loan Bank advances and other borrowings |  |  | 96,919 |  |  | 97,833 |  |  | — |  |  | 97,833 |  |  | — |
| Subordinated notes |  |  | 49,486 |  |  | 43,640 |  |  | — |  |  | 43,640 |  |  | — |
| Operating lease liabilities |  |  | 2,224 |  |  | 2,224 |  |  | — |  |  | 2,224 |  |  | — |
| Accrued interest payable |  |  | 1,136 |  |  | 1,136 |  |  | 1,136 |  |  | — |  |  | — |
|  |  | $ | 1,363,558 |  | $ | 1,359,091 |  | $ | 903,905 |  | $ | 143,697 |  | $ | 311,489 |

***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 March 31, 2020, 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:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| Commitments to extend credit |  | $ | 254,855 |  | $ | 240,758 |
| Commitments to originate residential first and second mortgage loans |  |  | 23,858 |  |  | 3,980 |
| Standby letters of credit |  |  | 83,937 |  |  | 97,348 |
| **Total** |  |  | 362,650 |  |  | 342,086 |

***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 March 31, 2020.

***Pending Litigation***

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

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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. |

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|  | · |  | 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:

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

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|  | · |  | 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:

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

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|  | · |  | 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, |

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|  | · |  | changes may occur in the securities markets and, |

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|  | · |  | effects of the COVID-19 pandemic, or other adverse external events. |

We have described under the caption *Risk Factors* in the Company’s Annual Report on Form 10‑K for the year ended December 31, 2019, and in other reports filed with the SEC from time to time, additional factors that could cause actual results to be materially different from those described in the forward-looking statements. Other factors that have not been identified in this report could also have this effect. You are cautioned not to put undue reliance on any forward-looking statement, which speak only as of the date they were made.

***Overview***

Crucial to the Company’s community banking strategy is growth in its commercial banking services, retail mortgage lending and retail banking services. Through the branch network of its subsidiary bank, the Company, with $1.5 billion in assets at March 31, 2020, 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, St. Louis, 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

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lending. The Company’s income from mortgage brokerage activities is directly dependent on mortgage rates and the level of home purchases and refinancing activity.

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

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

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

**Significant Developments and Transactions**

Each item listed below materially affects the comparability of our results of operations for the three months ended March 31, 2020 and 2019, and our financial condition as of March 31, 2020 and December 31, 2019, and may affect the comparability of financial information we report in future fiscal periods.

***Impact of COVID-19***. The progression of the COVID-19 pandemic in the United States has had an adverse impact on our financial condition and results of operations as of and for the three months ended March 31, 2020, and is expected to have a complex and significant adverse impact on the economy, the banking industry and our Company in future fiscal periods, all subject to a high degree of uncertainty.

*Effects on Our Market Areas.* Our commercial and consumer banking products and services are delivered primarily in Missouri, where individual and governmental responses to the COVID-19 pandemic have led to a broad curtailment of economic activity beginning March 2020. In Missouri, the Director of the Missouri Department of Health and Senior Services issued an order that individuals stay at home and that businesses abide by certain limitations on gathering sizes. This order was effective from April 6, 2020 and currently extends through May 3, 2020. Effective May 4, 2020, the governor of Missouri announced a partial relaxation of these limitations by lifting the stay at home order for individuals and allowing businesses to reopen subject to social distancing guidelines. The Bank and its branches have remained open during these orders because banking is deemed an essential business, although it has suspended lobby access at its branches from March 18, 2020 until May 4, 2020.

Missouri has experienced a dramatic increase in unemployment levels as a result of the curtailment of business activities, with over 400,000 new claims filed from March 14 through April 18, 2020, representing approximately 13% of Missouri’s labor force, according to the Missouri Department of Labor and Industrial Relations, and these levels are expected to rise further.

To date, the public health and economic effects of COVID-19 have been significant in larger metropolitan areas,  while management has observed that these effects have been much less significant in smaller cities and communities, where our banking operations are primarily focused.

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*Policy and Regulatory Developments*. Federal, state and local governments and regulatory authorities have enacted and issued a range of policy responses to the COVID-19 pandemic, including the following:

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|  | · |  | The Federal Reserve decreased the range for the federal funds target rate by 0.50% on March 3, 2020, and by another 1.0% on March 16, 2020, reaching a range of 0.0% – 0.25%. |

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| --- | --- | --- | --- |
|  | · |  | On April 9, 2020, the Federal Reserve announced additional measures aimed at supporting small and midsized business, as well as state and local governments impacted by COVID-19. The Federal Reserve announced the Main Street Business Lending Program, which establishes two new loan facilities intended to facilitate lending to small and midsized businesses: (1) the Main Street New Loan Facility (MSNLF), and (2) the Main Street Expanded Loan Facility (MSELF). MSNLF loans are unsecured term loans originated on or after April 8, 2020, while MSELF loans are provided as upsized tranches of existing loans originated before April 8, 2020. The combined size of the program will be up to $600 billion. The program is designed for businesses with up to 10,000 employees or $2.5 billion in 2019 revenues. To obtain a loan, borrowers must confirm that they are seeking financial support because of COVID-19 and that they will not use proceeds from the loan to pay off debt. The Federal Reserve also stated that it would provide additional funding to banks offering PPP loans to struggling small businesses. Lenders participating in the PPP will be able to exclude loans financed by the facility from their leverage ratio. In addition, the Federal Reserve created a Municipal Liquidity Facility to support state and local governments with up to $500 billion in lending, with the Treasury Department backing $35 billion for the facility using funds appropriated by the CARES Act. The facility will make short-term financing available to cities with a population of more than one million or counties with a population of greater than two million. The Federal Reserve expanded both the size and scope of its Primary and Secondary Market Corporate Credit Facilities to support up to $750 billion in credit to corporate debt issuers. This will allow companies that were investment grade before the onset of COVID-19 but then subsequently downgraded after March 22, 2020 to gain access to the facility. Finally, the Federal Reserve announced that its Term Asset-Backed Securities Loan Facility will be scaled up in scope to include the triple A-rated tranche of commercial mortgage-backed securities and newly issued collateralized loan obligations. The size of the facility is $100 billion. |

*Effects on Our Business.* The COVID-19 pandemic and the specific developments referred to above will continue to have a significant impact on our business. In particular, we anticipate that a significant portion of the Bank’s borrowers in the hotel, restaurant, gaming, long-term healthcare and retail industries will continue to endure significant economic distress, which has caused, and will continue to cause, them to draw on their existing lines of credit and adversely affect their ability to repay existing indebtedness, and is expected to adversely impact the value of collateral. These developments, together with economic conditions generally, are also expected to impact our commercial real estate portfolio, particularly with respect to real estate with exposure to these industries, our consumer loan business and loan portfolio, and the value of certain collateral securing our loans. As a result, we anticipate that our financial condition, capital levels and results of operations will be adversely affected, as described in further detail below.

*Our Response*. We have taken numerous steps in response to the COVID-19 pandemic, including the following:

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|  | · |  | To protect the health and safety of our employees and customers, on March 18, 2020, we closed our banking center lobbies but continued to serve clients by appointment or through our drive-up lanes. |

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|  | · |  | To meet the financial needs of our customers, we have instituted the following measures: |

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| --- | --- | --- | --- |
|  | o |  | The Company has received requests for payment modifications totaling $310 million through May 1, 2020 and we are working with our customers to address their specific needs. |

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|  | o |  | The Bank participated, as a lender, in the Small Business Administration ("SBA") Payroll Protection Program ("PPP") and began taking applications on the first day of the program. Through May 1, 2020, we had processed $80.0 million in PPP loans that had been approved by the SBA. |

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|  | o |  | To account for the probable increased losses inherent in the loan portfolio, Management recorded an additional $3.0 million provision for loan losses for the three months ended March 31, 2020. |

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.

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**SELECTED CONSOLIDATED FINANCIAL DATA**

The following table presents selected consolidated financial information for the Company as of and for each of the three months ended March 31, 2020 and 2019, respectively. The selected consolidated financial data should be read in conjunction with the unaudited consolidated financial statements of the Company, including the related notes, presented elsewhere herein.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
| **Selected Financial Data** |  |  |  |  |  |  |  |
|  |  | **Three Months Ended** | | | | |  |
|  |  | **March 31,** | | | | |  |
| **(In thousands, except per share data)** |  |  | **2020** |  |  | **2019** |  |
| **Per Share Data** |  |  |  |  |  |  |  |
| Basic earnings per share |  | $ | 0.14 |  | $ | 0.74 |  |
| Diluted earnings per share |  |  | 0.14 |  |  | 0.74 |  |
| Cash dividends paid on common stock |  |  | 753 |  |  | 603 |  |
| Book value per share |  |  | 18.64 |  |  | 16.75 |  |
| Market price per share |  |  | 18.35 |  |  | 22.35 |  |
| **Selected Ratios** |  |  |  |  |  |  |  |
| ***(Based on average balance sheets)*** |  |  |  |  |  |  |  |
| Return on total assets |  |  | 0.23 | % |  | 1.23 | % |
| Return on stockholders' equity |  |  | 2.96 | % |  | 18.41 | % |
| Stockholders' equity to total assets |  |  | 7.80 | % |  | 6.68 | % |
| Efficiency ratio (1) |  |  | 70.72 | % |  | 72.07 | % |
| Net interest spread |  |  | 3.28 | % |  | 2.96 | % |
| Net interest margin |  |  | 3.55 | % |  | 3.27 | % |
|  |  |  |  |  |  |  |  |
| ***(Based on end-of-period data)*** |  |  |  |  |  |  |  |
| Stockholders' equity to assets |  |  | 7.64 | % |  | 6.82 | % |
| Total risk-based capital ratio |  |  | 14.80 | % |  | 13.39 | % |
| Tier 1 risk-based capital ratio |  |  | 12.81 | % |  | 11.41 | % |
| Common equity Tier 1 capital |  |  | 9.64 | % |  | 8.65 | % |
| Tier 1 leverage ratio (2) |  |  | 10.43 | % |  | 9.38 | % |

(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 adjustments to exclude the additional loan loss provision recorded in the quarter ended March 31, 2020 caused by the impact on current economic conditions due to the COVID-19 pandemic and the impact of the gain on the sale of our Branson branch that closed during the quarter ended March 31, 2019. The Company believes that the exclusion of these items 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** | | | | |  |
| (In thousands, except per share data) |  | **March 31,** | | | | |  |
| Net income - GAAP |  | $ | 868 |  | $ | 4,666 |  |
| Effect of ALL provision COVID-19 (a) |  |  | 2,370 |  |  | — |  |
| Effect of net gain on branch sale (b) |  |  | — |  |  | (1,638) |  |
| Net income - non-GAAP |  | $ | 3,238 |  | $ | 3,028 |  |
|  |  |  |  |  |  |  |  |
| **Per Share Data** |  |  |  |  |  |  |  |
| Basic earnings per share - GAAP |  | $ | 0.14 |  | $ | 0.74 |  |
| Effect of ALL provision COVID-19 (a) |  |  | 0.38 |  |  | — |  |
| Effect of net gain on branch sale (b) |  |  | — |  |  | (0.26) |  |
| Basic earnings per share - non-GAAP |  | $ | 0.52 |  | $ | 0.48 |  |
| Diluted earnings per share - GAAP |  | $ | 0.14 |  | $ | 0.74 |  |
| Effect of ALL provision COVID-19 (a) |  |  | 0.38 |  |  | — |  |
| Effect of net gain on branch sale (b) |  |  | — |  |  | (0.26) |  |
| Diluted earnings per share - non-GAAP |  | $ | 0.52 |  | $ | 0.48 |  |
|  |  |  |  |  |  |  |  |
| **Key Ratios** |  |  |  |  |  |  |  |
| Return on average total assets - GAAP |  |  | 0.23 | % |  | 1.23 | % |
| Effect of ALL provision COVID-19 (a) |  |  | 0.63 |  |  | — |  |
| Effect of net gain on branch sale (b) |  |  | — |  |  | (0.43) |  |
| Return on average total assets - non-GAAP |  |  | 0.86 | % |  | 0.80 | % |
| Return on average stockholders' equity - GAAP |  |  | 2.96 | % |  | 18.41 | % |
| Effect of ALL provision COVID-19 (a) |  |  | 8.08 |  |  | — |  |
| Effect of net gain on branch sale (b) |  |  | — |  |  | (6.46) |  |
| Return on average stockholders' equity - non-GAAP |  |  | 11.04 | % |  | 11.95 | % |

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| --- | --- | --- | --- |
|  | (a) |  | An additional $3.0 million ALL provision pre-tax and $2.4 million after tax was recorded during the quarter due to current economic conditions resulting from the COVID-19 pandemic. |

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|  | (b) |  | The gain on the sale of the Branson Branch was $2.1 million pre-tax and $1.6 million after tax for the three months ended March 31, 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 March 31,** | | | | | | | | | | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  | **$ Change** | |  | **% Change** | |  |
| Net interest income |  | $ | 12,526 |  | $ | 11,629 |  | $ | 897 |  |  | 7.7 | % |
| Provision for loan losses |  |  | 3,300 |  |  | 150 |  |  | 3,150 |  |  | NM |  |
| Non-interest income |  |  | 2,248 |  |  | 2,091 |  |  | 157 |  |  | 7.5 |  |
| Investment securities (losses) gains, net |  |  | (1) |  |  | 1 |  |  | (2) |  |  | (200.0) |  |
| Gain on branch sale, net |  |  | — |  |  | 2,074 |  |  | (2,074) |  |  | (100.0) |  |
| Non-interest expense |  |  | 10,448 |  |  | 9,888 |  |  | 560 |  |  | 5.7 |  |
| **Income before income taxes** |  |  | 1,025 |  |  | 5,757 |  |  | (4,732) |  |  | (82.2) |  |
| Income tax expense |  |  | 157 |  |  | 1,091 |  |  | (934) |  |  | (85.6) |  |
| **Net income** |  | $ | 868 |  | $ | 4,666 |  | $ | (3,798) |  |  | (81.4) | % |

NM = not meaningful

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***Consolidated net income*** of $868,000, or $0.14 per diluted share, for the three months ended March 31, 2020 decreased $3.8 million compared to $4.7 million, or $0.74 per diluted share, for the three months ended March 31, 2019. For the three months ended March 31, 2020, the return on average assets was 0.23%, the return on average stockholders’ equity was 2.96%, and the efficiency ratio was 70.7%.

***Net interest income*** was $12.5 million for the three months ended March 31, 2020 compared to $11.6 million for the three months ended March 31, 2019. The net interest margin (expressed on a fully taxable equivalent basis) increased to 3.55% for the three months ended March 31, 2020, compared to 3.27% for the three months ended March 31, 2019. These changes are discussed in greater detail under the *Average Balance Sheets and Rate and Volume Analysis* section below.

A $3.3 million ***provision for loan losses*** was required for the three months ended March 31, 2020 compared to a $150,000 provision for the three months ended March 31, 2019. In March of 2020, an additional $3.0 million was recorded during the quarter due to current economic conditions resulting from the COVID-19 pandemic.

The Company’s net loan charge-offs were $84,000 for the three months ended March 31, 2020,  compared to net recoveries of $43,000 for the three months ended March 31, 2019.

Non-performing loans totaled $8.1 million, or 0.68% of total loans, at March 31, 2020 compared to $5.1 million, or 0.43% of total loans, at December 31, 2019, and $5.6 million, or 0.48% of total loans, at March 31, 2019. These changes are discussed in greater detail under the *Lending and Credit Management* section below.

***Non-interest income*** increased $157,000, or 7.5%, for the three months ended March 31, 2020 compared to the three months ended March 31, 2019. These changes are discussed in greater detail under the *Non-interest Income and Expense* section below.

***Investment securities (losses) gains, net*** The Company recognized an unrealized loss of $1,000 for the three months ended March 31, 2020, compared to an unrealized gain of $1,000 for the three months ended March 31, 2019 related to equity securities. These changes are discussed in greater detail under *Investment securities (losses) gains, net* section below.

***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 $2.1 million, or $1.6 million after tax for the three months ended March 31, 2019.

***Non-interest expense*** increased $560,000, or 5.7%, for the three months ended March 31, 2020 compared to the three months ended March 31, 2019. These changes are discussed in greater detail under the *Non-interest Income and Expense* section below.

***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

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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 March 31, 2020 and 2019, respectively.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | | | | | | | | | | | | |
|  |  | **2020** | | | | | | |  | **2019** | | | | | | |  |
|  |  |  |  |  | **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) (3)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial |  | $ | 199,082 |  | $ | 2,570 |  | 5.19 | % | $ | 205,728 |  | $ | 2,742 |  | 5.41 | % |
| Real estate construction - residential |  |  | 23,467 |  |  | 323 |  | 5.54 |  |  | 28,454 |  |  | 420 |  | 5.99 |  |
| Real estate construction - commercial |  |  | 85,573 |  |  | 1,108 |  | 5.21 |  |  | 109,769 |  |  | 1,403 |  | 5.18 |  |
| Real estate mortgage - residential |  |  | 250,757 |  |  | 3,132 |  | 5.02 |  |  | 243,853 |  |  | 3,047 |  | 5.07 |  |
| Real estate mortgage - commercial |  |  | 573,133 |  |  | 7,005 |  | 4.92 |  |  | 526,069 |  |  | 6,240 |  | 4.81 |  |
| Installment and other consumer |  |  | 31,441 |  |  | 357 |  | 4.57 |  |  | 32,238 |  |  | 336 |  | 4.23 |  |
| **Total loans** |  | $ | 1,163,453 |  | $ | 14,495 |  | 5.01 | % | $ | 1,146,111 |  | $ | 14,188 |  | 5.02 | % |
| **Loans held for sale** |  | $ | 1,892 |  | $ | 5 |  | 1.06 | % | $ | 490 |  | $ | — |  | — | % |
| **Investment securities:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  | $ | 758 |  | $ | 4 |  | 2.12 | % | $ | 2,491 |  | $ | 13 |  | 2.12 | % |
| U.S. government and federal agency obligations |  |  | 37,167 |  |  | 195 |  | 2.11 |  |  | 51,963 |  |  | 239 |  | 1.87 |  |
| Obligations of states and political subdivisions |  |  | 36,785 |  |  | 270 |  | 2.95 |  |  | 38,937 |  |  | 255 |  | 2.66 |  |
| Mortgage-backed securities |  |  | 104,029 |  |  | 525 |  | 2.03 |  |  | 116,330 |  |  | 667 |  | 2.33 |  |
| Other debt securities |  |  | 4,402 |  |  | 60 |  | 5.48 |  |  | 4,409 |  |  | 64 |  | 5.89 |  |
| **Total investment securities** |  | $ | 183,141 |  | $ | 1,054 |  | 2.31 | % | $ | 214,130 |  | $ | 1,238 |  | 2.34 | % |
| Other investment securities |  |  | 6,253 |  |  | 100 |  | 6.43 |  |  | 5,677 |  |  | 66 |  | 4.71 |  |
| Federal funds sold and interest bearing deposits in other financial institutions |  |  | 82,215 |  |  | 325 |  | 1.59 |  |  | 99,013 |  |  | 602 |  | 2.47 |  |
| **Total interest earning assets** |  | $ | 1,436,954 |  | $ | 15,979 |  | 4.47 | % | $ | 1,465,421 |  | $ | 16,094 |  | 4.45 | % |
| All other assets |  |  | 83,136 |  |  |  |  |  |  |  | 84,740 |  |  |  |  |  |  |
| Allowance for loan losses |  |  | (12,584) |  |  |  |  |  |  |  | (11,786) |  |  |  |  |  |  |
| **Total assets** |  | $ | 1,507,506 |  |  |  |  |  |  | $ | 1,538,375 |  |  |  |  |  |  |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| NOW accounts |  | $ | 185,642 |  | $ | 290 |  | 0.63 | % | $ | 238,076 |  | $ | 781 |  | 1.33 | % |
| Savings |  |  | 100,862 |  |  | 22 |  | 0.09 |  |  | 92,426 |  |  | 17 |  | 0.07 |  |
| Interest checking |  |  | 47,295 |  |  | 173 |  | 1.47 |  |  | 10,556 |  |  | 49 |  | 1.88 |  |
| Money market |  |  | 270,520 |  |  | 462 |  | 0.69 |  |  | 295,335 |  |  | 869 |  | 1.19 |  |
| Time deposits |  |  | 323,103 |  |  | 1,165 |  | 1.45 |  |  | 362,660 |  |  | 1,371 |  | 1.53 |  |
| **Total interest bearing deposits** |  | $ | 927,422 |  | $ | 2,112 |  | 0.92 | % | $ | 999,053 |  | $ | 3,087 |  | 1.25 | % |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 26,290 |  |  | 37 |  | 0.57 |  |  | 20,836 |  |  | 33 |  | 0.64 |  |
| Federal Home Loan Bank advances and other borrowings |  |  | 108,031 |  |  | 632 |  | 2.35 |  |  | 95,133 |  |  | 542 |  | 2.31 |  |
| Subordinated notes |  |  | 49,486 |  |  | 501 |  | 4.07 |  |  | 49,486 |  |  | 624 |  | 5.11 |  |
| **Total borrowings** |  | $ | 183,807 |  | $ | 1,170 |  | 2.56 | % | $ | 165,455 |  | $ | 1,199 |  | 2.94 | % |
| **Total interest bearing liabilities** |  | $ | 1,111,229 |  | $ | 3,282 |  | 1.19 | % | $ | 1,164,508 |  | $ | 4,286 |  | 1.49 | % |
| Demand deposits |  |  | 261,244 |  |  |  |  |  |  |  | 256,014 |  |  |  |  |  |  |
| Other liabilities |  |  | 17,433 |  |  |  |  |  |  |  | 15,049 |  |  |  |  |  |  |
| **Total liabilities** |  |  | 1,389,906 |  |  |  |  |  |  |  | 1,435,571 |  |  |  |  |  |  |
| Stockholders' equity |  |  | 117,600 |  |  |  |  |  |  |  | 102,804 |  |  |  |  |  |  |
| **Total liabilities and stockholders' equity** |  | $ | 1,507,506 |  |  |  |  |  |  | $ | 1,538,375 |  |  |  |  |  |  |
| **Net interest income (FTE)** |  |  |  |  | $ | 12,697 |  |  |  |  |  |  | $ | 11,808 |  |  |  |
| **Net interest spread** |  |  |  |  |  |  |  | 3.28 | % |  |  |  |  |  |  | 2.96 | % |
| **Net interest margin** |  |  |  |  |  |  |  | 3.55 | % |  |  |  |  |  |  | 3.27 | % |

(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 March 31, 2020 and 2019. Such adjustments totaled $171,000 and $179,000 for the three months ended March 31, 2020 and 2019, respectively.

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

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

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***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 months ended March 31, 2020 compared to the three months ended March 31, 2019. The change in interest due to the combined rate/volume variance has been allocated to rate and volume changes in proportion to the absolute dollar amounts of change in each.

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | | | | |  |
|  |  | **2020 vs. 2019** | | | | | | | |  |
|  |  |  |  |  | **Change due to** | | | | |  |
|  |  | **Total** | |  | **Average** | |  | **Average** | |  |
| *(In thousands)* |  | **Change** | |  | **Volume** | |  | **Rate** | |  |
| **Interest income on a fully taxable equivalent basis: (1)** |  |  |  |  |  |  |  |  |  |  |
| **Loans: (2) (3)** |  |  |  |  |  |  |  |  |  |  |
| Commercial |  | $ | (172) |  | $ | (88) |  | $ | (84) |  |
| Real estate construction - residential |  |  | (97) |  |  | (71) |  |  | (26) |  |
| Real estate construction - commercial |  |  | (295) |  |  | (314) |  |  | 19 |  |
| Real estate mortgage - residential |  |  | 85 |  |  | 86 |  |  | (1) |  |
| Real estate mortgage - commercial |  |  | 765 |  |  | 572 |  |  | 193 |  |
| Installment and other consumer |  |  | 21 |  |  | (8) |  |  | 29 |  |
| **Loans held for sale** |  |  | 5 |  |  | — |  |  | 5 |  |
| **Investment securities:** |  |  |  |  |  |  |  |  |  |  |
| U.S. Treasury |  |  | (9) |  |  | (9) |  |  | — |  |
| U.S. government and federal agency obligations |  |  | (44) |  |  | (75) |  |  | 31 |  |
| Obligations of states and political subdivisions |  |  | 15 |  |  | (15) |  |  | 30 |  |
| Mortgage-backed securities |  |  | (142) |  |  | (67) |  |  | (75) |  |
| Other debt securities |  |  | (4) |  |  | — |  |  | (4) |  |
| Other investment securities |  |  | 34 |  |  | 8 |  |  | 26 |  |
| Federal funds sold and interest bearing deposits in other financial institutions |  |  | (277) |  |  | (90) |  |  | (187) |  |
| **Total interest income** |  |  | (115) |  |  | (71) |  |  | (44) |  |
| **Interest expense:** |  |  |  |  |  |  |  |  |  |  |
| NOW accounts |  |  | (491) |  |  | (145) |  |  | (346) |  |
| Savings |  |  | 5 |  |  | 2 |  |  | 3 |  |
| Interest checking |  |  | 124 |  |  | 137 |  |  | (13) |  |
| Money market |  |  | (407) |  |  | (68) |  |  | (339) |  |
| Time deposits |  |  | (206) |  |  | (145) |  |  | (61) |  |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 4 |  |  | 8 |  |  | (4) |  |
| Federal Home Loan Bank advances and other borrowings |  |  | 90 |  |  | 75 |  |  | 15 |  |
| Subordinated notes |  |  | (123) |  |  | — |  |  | (123) |  |
| **Total interest expense** |  |  | (1,004) |  |  | (136) |  |  | (868) |  |
| **Net interest income on a fully taxable equivalent basis** |  | $ | 889 |  | $ | 65 |  | $ | 824 |  |

(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 March 31, 2020 and 2019. Such adjustments totaled $171,000 for the three months ended March 31, 2020 compared to $179,000 for the three months ended March 31, 2019.

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

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

Financial results for the quarter ended March 31, 2020 compared to the quarter ended March 31, 2019, reflected an increase in net interest income, on a tax equivalent basis, of $889,000, or 7.53%. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) increased to 3.55% for the quarter ended March 31, 2020, compared to 3.27% for the quarter ended March 31, 2019. Net interest income and net interest margin increased primarily due to an increase in average loan balances along with a decrease in average interest bearing liabilities and rates paid in the three month comparative periods.

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Average interest-earning assets decreased $28.5 million, or 1.94%, to $1.44 billion for the three months ended March 31, 2020 compared to $1.47 billion for the three months ended March 31, 2019, and average interest bearing liabilities decreased $53.3 million, or 4.58%, to $1.11 billion for the three months ended March 31, 2020 compared to $1.16 billion for the three months ended March 31, 2019.

***Total interest income*** (expressed on a fully taxable equivalent basis) was $16.0 million for the three ended March 31, 2020 compared to $16.1 million for the three months ended March 31, 2019. The Company’s rates earned on interest earning assets were 4.47% for the three months ended March 31, 2020 compared to 4.45% for the three months ended March 31, 2019.

***Interest income on loans*** increased to $14.5million for the three months ended March 31, 2020 compared to $14.2 million for the three ended March 31, 2019.

Average loans outstanding increased $17.3 million, or 1.51%, to $1.16 billion for the three months ended March 31, 2020 compared to $1.15 billion for the three months ended March 31, 2019. The average yield on loans decreased to 5.01% for the three months ended March 31, 2020 compared to 5.02% for the three months ended March 31, 2019. See the *Lending and Credit Management* section for further discussion of changes in the composition of the lending portfolio.

***Total interest expense*** decreased to $3.3 million for the three months ended March 31, 2020 compared to $4.3 million for the three months ended March 31, 2019. The Company’s rates paid on interest bearing liabilities were 1.19% for the three months ended March 31, 2020 compared to 1.49% for the three months ended March 31, 2019. See the *Liquidity Management* section for further discussion.

***Interest expense on deposits*** decreased to $2.1 million for the three months ended March 31, 2020 compared to $3.1 million for the three months ended March 31, 2019, respectively.

Average interest bearing deposits decreased $71.6 million, or 7.17%, to $927.4 million for the three months ended March 31, 2020 compared to $999.1 million for the three months ended March 31, 2019.  These decreases were primarily due to a decrease in public funds resulting from the loss of a public fund account at renewal, decreases in NOW accounts, brokered and CDAR certificates of deposits due to lower market rates paid during the current quarter. The average cost of deposits decreased to 0.92% for the three months ended March 31, 2020 compared to 1.25% for the three months ended March 31, 2019. The decrease was primarily due to generally lower market interest rates quarter over quarter.

***Interest expense on borrowings*** was approximately $1.2 million for both the three months ended March 31, 2020 and 2019, respectively.

Average borrowings increased to $183.8 million for the three months ended March 31, 2020 compared to $165.5 million for the three months ended March 31, 2019. The increase in average borrowings was primarily due to an increase in FHLB advances to fund liquidity needs. The average cost of borrowings decreased to 2.56% for the three months ended March 31, 2020 compared to 2.94% for the three months ended March 13, 2019. The decrease in cost of funds primarily resulted from lower market interest rates.  See the *Liquidity Management* section for further discussion.

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

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | | | | | | | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  | **$ Change** | |  | **% Change** | |  |
| **Non-interest income** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Service charges and other fees |  | $ | 799 |  | $ | 862 |  | $ | (63) |  |  | (7.3) | % |
| Bank card income and fees |  |  | 693 |  |  | 695 |  |  | (2) |  |  | (0.3) |  |
| Trust department income |  |  | 379 |  |  | 293 |  |  | 86 |  |  | 29.4 |  |
| Real estate servicing fees, net |  |  | (87) |  |  | 84 |  |  | (171) |  |  | (203.6) |  |
| Gain on sales of mortgage loans, net |  |  | 419 |  |  | 105 |  |  | 314 |  |  | 299.0 |  |
| Other |  |  | 45 |  |  | 52 |  |  | (7) |  |  | (13.5) |  |
| **Total non-interest income** |  | $ | 2,248 |  | $ | 2,091 |  | $ | 157 |  |  | 7.5 | % |
| Non-interest income as a % of total revenue \* |  |  | 15.2 | % |  | 15.2 | % |  |  |  |  |  |  |

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

***Total non-interest income*** increased $157,000, or 7.5%, to $2.2 million for the quarter ended March 31, 2020 compared to $2.1 million for the quarter ended March 31, 2019.

***Service charges and fees*** decreased $63,000, or 7.3%, to $799,000 for the quarter ended March 31, 2020 compared to $862,000 for the quarter ended March 31, 2019. The decrease in fees was a result in a change to the nonsufficient funds service charges (NSF) in 2019.

***Trust department income*** increased $86,000, or 29.4%, to $379,000 for the quarter ended March 31, 2020 compared to $293,000 for the quarter ended March 31, 2019. The increase was primarily due to one-time fees received during the first quarter ended March 31, 2020. The Company also added new Trust department personnel during the fourth quarter of 2019.

***Real estate servicing fees, net*** of the change in valuation of mortgage servicing rights (MSRs) decreased $171,000, or 203.6%, to $(87,000) for the quarter ended March 31, 2020 compared to $84,000 for the quarter ended March 31, 2019.

Mortgage loan servicing fees earned on loans sold were $188,000 for the three months ended March 31, 2020 compared to $178,000 for the three months ended March 31, 2019. The current quarter's MSR valuation decreased $275,000 from December 31, 2019 primarily due to increased prepayment assumptions. There was a dramatic drop in rates from December 31, 2019 to March 31, 2020, especially in the ten year Treasury rate resulting in an incentive for borrowers to refinance their existing loans.

The Company was servicing $270.6 million of mortgage loans at March 31, 2020 compared to $271.4 million and $275.7 million at December 31, 2019 and March 31, 2019, respectively.

***Gain on sales of mortgage loans*** increased $314,000, or 299.0%, to $419,000 for the quarter ended March 31, 2020 compared to $105,000 for the quarter ended March 31, 2019. During the fourth quarter of 2019, the Company focused on the growth of a new mortgage loan department and began offering new mortgage loan products in addition to Freddie and Fannie loans. The Company sold $13.2 million of loans for the three months ended March 31, 2020 compared to $5.1 million for the three months ended March 31, 2019.

***Other Income*** decreased $7,000, or 13.5%, to $45,000 for the quarter ended March 31, 2020 compared to $52,000 for the quarter ended March 31, 2019. The decrease in the current quarter was primarily due to decreased brokerage income, and insurance commissions and a decrease in income earned on bank owned life insurance policies due to one of the Company's polices being redeemed in the third quarter of 2019.

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | |
| *(in thousands)* |  | **2020** | |  | **2019** | |
| ***Investment securities (losses) gains, net*** |  |  |  |  |  |  |
| **Available for sale securities:** |  |  |  |  |  |  |
| Gains realized on sales |  | $ | — |  | $ | — |
| Losses realized on sales |  |  | — |  |  | — |
| Other-than-temporary impairment recognized |  |  | — |  |  | — |
| **Other investment securities:** |  |  |  |  |  |  |
| Fair value adjustments, net |  |  | (1) |  |  | 1 |
| **Investment securities (losses) gains, net** |  | **$** | **(1)** |  | **$** | **1** |

During the three months ended March 31, 2020, the Company received $681,000 from the proceeds from the sale of available for sale debt securities and recognized an immaterial gain. There were no securities sales during the three months ended March 31, 2019. The Company recognized an unrealized loss of $1,000 for the three months ended March 31, 2020, compared to an unrealized gain of $1,000 for the three months ended March 31, 2019 related to equity securities.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Three Months Ended March 31,** | | | | | | | | | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  | **$ Change** | |  | **% Change** |  |
| **Non-interest expense** |  |  |  |  |  |  |  |  |  |  |  |  |
| Salaries |  | $ | 4,512 |  | $ | 3,972 |  | $ | 540 |  | 13.6 | % |
| Employee benefits |  |  | 1,609 |  |  | 1,466 |  |  | 143 |  | 9.8 |  |
| Occupancy expense, net |  |  | 766 |  |  | 698 |  |  | 68 |  | 9.7 |  |
| Furniture and equipment expense |  |  | 695 |  |  | 809 |  |  | (114) |  | (14.1) |  |
| Processing, network and bank card expense |  |  | 976 |  |  | 1,001 |  |  | (25) |  | (2.5) |  |
| Legal, examination, and professional fees |  |  | 367 |  |  | 329 |  |  | 38 |  | 11.6 |  |
| Advertising and promotion |  |  | 249 |  |  | 258 |  |  | (9) |  | (3.5) |  |
| Postage, printing, and supplies |  |  | 241 |  |  | 210 |  |  | 31 |  | 14.8 |  |
| Other |  |  | 1,033 |  |  | 1,145 |  |  | (112) |  | (9.8) |  |
| **Total non-interest expense** |  | $ | 10,448 |  | $ | 9,888 |  | $ | 560 |  | 5.7 | % |
| Efficiency ratio\* |  |  | 70.7 | % |  | 72.1 | % |  |  |  |  |  |
| Number of full-time equivalent employees |  |  | 303 |  |  | 286 |  |  |  |  |  |  |

\*Efficiency ratio is calculated as non-interest expense as a percent of revenue. Total revenue includes net interest income and non-interest income.

***Total non-interest expense*** increased $560,000, or 5.7%, to $10.4 million for the quarter ended March 31, 2020 compared to $9.9 million for the quarter ended March 31, 2019.

***Salaries*** increased $540,000, or 13.6%, to $4.5 million for the quarter ended March 31, 2020 compared to $4.0 million for the quarter ended March 31, 2019.  The increase was primarily due to adding 17 full-time equivalent (FTE) employees to expand the Company's new mortgage loan department. In addition, annual merit increases average approximately 4.0% each year and are granted in the first quarter of each year.

***Employee benefits*** increased $143,000, or 9.8%, to $1.6 million for the quarter ended March 31, 2020 compared to $1.5 million for the quarter ended March 31, 2019. The increase for the quarter ended March 31, 2020 over the quarter ended March 31, 2019 was primarily due to higher pension cost due to lower annual discount rate assumptions compared to the prior year's annual assumptions, an increase in payroll taxes due to increase in FTE mentioned above, partially offset by a decrease in medical plan premiums due to savings realized from fewer benefit claims.

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***Furniture and equipment expense*** decreased $114,000, or 14.1%, to $695,000 for the quarter ended March 31, 2020 compared to $809,000 for the quarter ended March 31, 2019. The decrease for the quarter ended March 31, 2020 over the quarter ended March 31, 2019 was primarily due to a decrease in reoccurring core maintenance agreement expenses. In addition, the Company recognized a $55,000 gain on sale of land adjacent to one of its branches.

***Other non-interest expense*** decreased $112,000, or 9.8%, to $1.0 million for the quarter ended March 31, 2020 compared to $1.1 million for the quarter ended March 31, 2019. The decrease was primarily related to a FDIC assessment credit received in the third quarter of 2019 through the first quarter of 2020, a decrease in real estate foreclosure expenses, and a decrease in insurance expense.

***Income taxes***

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 15.3% for the three months ended March 31, 2020 compared to 18.9% for the three months ended March  31, 2019.  The decrease in the effective tax rate was primarily attributable to the impact of tax-free revenues having a greater impact to pre-tax income due to the reduced level of earnings this quarter.

**Lending and Credit Management**

Interest earned on the loan portfolio is a primary source of interest income for the Company. Net loans represented 76.3% of total assets as of March 31, 2020 compared to 77.5% as of December 31, 2019.

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

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  |
| Commercial, financial, and agricultural |  | $ | 205,657 |  | $ | 199,022 |  |
| Real estate construction - residential |  |  | 23,913 |  |  | 23,035 |  |
| Real estate construction - commercial |  |  | 87,497 |  |  | 84,998 |  |
| Real estate mortgage - residential |  |  | 246,859 |  |  | 252,643 |  |
| Real estate mortgage - commercial |  |  | 585,900 |  |  | 576,635 |  |
| Installment and other consumer |  |  | 30,696 |  |  | 32,464 |  |
| **Total loans** |  | $ | 1,180,522 |  | $ | 1,168,797 |  |
| **Percent of categories to total loans:** |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  |  | 17.4 | % |  | 17.0 | % |
| Real estate construction - residential |  |  | 2.0 |  |  | 2.0 |  |
| Real estate construction - commercial |  |  | 7.4 |  |  | 7.3 |  |
| Real estate mortgage - residential |  |  | 20.9 |  |  | 21.6 |  |
| Real estate mortgage - commercial |  |  | 49.6 |  |  | 49.3 |  |
| Installment and other consumer |  |  | 2.6 |  |  | 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.

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The Company generally does not retain long-term fixed rate residential mortgage loans in its portfolio. Fixed rate loans conforming to standards required by the secondary market are offered to qualified borrowers, but are not funded until the Company has a non-recourse purchase commitment from the secondary market at a predetermined price. During the three months ended March 31, 2020, the Company sold approximately $13.2 million of loans to investors, compared to $5.1 million for the three months ended March 31, 2019. At March 31, 2020, the Company was servicing approximately $270.6 million of loans sold to the secondary market compared to $271.4 million at December 31, 2019, and $275.7 million at March 31, 2019.

*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.

*Non-performing Assets*

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

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |  | **March 31,** | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  | **2019** | |  |
| **Nonaccrual loans:** |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  | $ | 3,111 |  | $ | 982 |  | $ | 1,747 |  |
| Real estate construction - residential |  |  | — |  |  | — |  |  | — |  |
| Real estate construction - commercial |  |  | 408 |  |  | 137 |  |  | 151 |  |
| Real estate mortgage - residential |  |  | 3,211 |  |  | 2,135 |  |  | 2,803 |  |
| Real estate mortgage - commercial |  |  | 1,068 |  |  | 1,359 |  |  | 508 |  |
| Installment and other consumer |  |  | 46 |  |  | 141 |  |  | 222 |  |
| **Total** |  | $ | 7,844 |  | $ | 4,754 |  | $ | 5,431 |  |
| **Loans contractually past - due 90 days or more and still accruing:** |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  | $ | — |  | $ | — |  | $ | — |  |
| Real estate construction - residential |  |  | — |  |  | — |  |  | — |  |
| Real estate construction - commercial |  |  | — |  |  | — |  |  | — |  |
| Real estate mortgage - residential |  |  | 190 |  |  | 304 |  |  | 140 |  |
| Real estate mortgage - commercial |  |  | — |  |  | — |  |  | — |  |
| Installment and other consumer |  |  | 27 |  |  | 12 |  |  | 5 |  |
| **Total** |  | $ | 217 |  | $ | 316 |  | $ | 145 |  |
| **Total non-performing loans (a)** |  |  | 8,061 |  |  | 5,070 |  |  | 5,576 |  |
| **Other real estate owned and repossessed assets** |  |  | 12,769 |  |  | 12,781 |  |  | 13,537 |  |
| **Total non-performing assets** |  | $ | 20,830 |  | $ | 17,851 |  | $ | 19,113 |  |

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|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |
| Loans held for investment |  | $ | 1,180,522 |  | $ | 1,168,797 |  | $ | 1,153,640 |  |
| Allowance for loan losses to loans |  |  | 1.33 | % |  | 1.07 | % |  | 1.03 | % |
| Non-performing loans to loans (a) |  |  | 0.68 | % |  | 0.43 | % |  | 0.48 | % |
| Non-performing assets to loans (b) |  |  | 1.76 | % |  | 1.53 | % |  | 1.66 | % |
| Non-performing assets to assets (b) |  |  | 1.36 | % |  | 1.20 | % |  | 1.24 | % |
| Allowance for loan losses to non-performing loans |  |  | 194.68 | % |  | 246.09 | % |  | 212.43 | % |

|  |  |  |  |
| --- | --- | --- | --- |
|  | (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 $20.8 million, or 1.76% of total loans, at March 31, 2020 compared to $17.9 million, or 1.53% of total loans, at December 31, 2019, and $19.1 million, or 1.66% of total loans, at March 31, 2019, respectively. Non-performing loans included $1.2 million of loans classified as TDRs at March 31, 2020 compared to $1.6 million and $1.9 million at December 31, 2019 and March 31, 2019, respectively.

As of March 31, 2020, approximately $5.8 million compared to $9.0 million and $5.4 million at December 31, 2019 and March 31, 2019, respectively, of loans classified as substandard, which include performing TDRs, and are not included in the non-performing 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 March 31, 2020 and December 31, 2019, respectively.

Total non-accrual loans at March 31, 2020 increased $3.1 million, 65.0%, to $7.8 million compared to $4.8 million at December 31, 2019. The increase in non-accrual loans primarily consisted of increases in commercial, financial, and agricultural loans, and real estate mortgage residential loans related to one loan relationship.

Loans past due 90 days and still accruing interest at March 31, 2020, were $217,000 compared to $316,000 at December 31, 2019. Other real estate and repossessed assets were $12.8 million at March 31, 2020 and December 31, 2019, respectively. During the three months ended March 31, 2020, there were no non-accrual loans, net of charge-offs taken, moved to other real estate owned and repossessed assets compared to $116,000 during the three months ended March 31, 2019.

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **March 31, 2020** | | | | | | |  | **December 31, 2019** | | | | | | |
|  |  | **Number of** |  | **Recorded** | |  | **Specific** | |  | **Number of** |  | **Recorded** | |  | **Specific** | |
| *(In thousands)* |  | **contracts** |  | **Investment** | |  | **Reserves** | |  | **contracts** |  | **Investment** | |  | **Reserves** | |
| **Performing TDRs** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | 5 |  | $ | 521 |  | $ | 175 |  | 5 |  | $ | 532 |  | $ | 177 |
| Real estate mortgage - residential |  | 6 |  |  | 1,554 |  |  | 32 |  | 6 |  |  | 1,615 |  |  | 33 |
| Real estate mortgage - commercial |  | 2 |  |  | 350 |  |  | 7 |  | 2 |  |  | 352 |  |  | 7 |
| Installment and other consumer |  | 5 |  |  | 88 |  |  | 7 |  | 2 |  |  | 36 |  |  | 2 |
| **Total performing TDRs** |  | 18 |  | $ | 2,513 |  | $ | 221 |  | 15 |  | $ | 2,535 |  | $ | 219 |
| **Non-performing TDRs** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial, financial and agricultural |  | 6 |  | $ | 480 |  | $ | 77 |  | 6 |  | $ | 496 |  | $ | 99 |
| Real estate mortgage - residential |  | 6 |  |  | 757 |  |  | 76 |  | 6 |  |  | 782 |  |  | 117 |
| Real estate mortgage - commercial |  | 1 |  |  | 6 |  |  | 1 |  | 2 |  |  | 266 |  |  | — |
| Installment and other consumer |  | — |  |  | — |  |  | — |  | 2 |  |  | 72 |  |  | 7 |
| **Total non-performing TDRs** |  | 13 |  | $ | 1,243 |  | $ | 154 |  | 16 |  | $ | 1,616 |  | $ | 223 |
| **Total TDRs** |  | 31 |  | $ | 3,756 |  | $ | 375 |  | 31 |  | $ | 4,151 |  | $ | 442 |

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At March 31, 2020, loans classified as TDRs totaled $3.8 million, with $375,000 of specific reserves compared to $4.2 million of loans classified as TDRs, with $442,000 of specific reserves at December 31, 2019. 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, 2019 to March 31, 2020 was primarily due to $383,000 of payments received on TDRs, partially offset by one new TDR totaling $6,000.

**Allowance for Loan Losses and Provision**

*Allowance for Loan Losses*

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  |
| **Allocation of allowance for loan losses at end of period:** |  |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  | $ | 3,623 |  | $ | 2,918 |  |
| Real estate construction - residential |  |  | 117 |  |  | 64 |  |
| Real estate construction - commercial |  |  | 622 |  |  | 369 |  |
| Real estate mortgage - residential |  |  | 2,363 |  |  | 2,118 |  |
| Real estate mortgage - commercial |  |  | 8,614 |  |  | 6,547 |  |
| Installment and other consumer |  |  | 351 |  |  | 381 |  |
| Unallocated |  |  | 3 |  |  | 80 |  |
| **Total** |  | $ | 15,693 |  | $ | 12,477 |  |

The allowance for loan losses (ALL) was $15.7 million, or 1.33% of loans outstanding, at March 31, 2020 compared to $12.5 million, or 1.07%, at December 31, 2019, and $11.8 million, or 1.03% at March 31, 2019. The ratio of the allowance for loan losses to nonperforming loans was 194.68% at March 31, 2020, compared to 246.09% at December 31, 2019, and 212.43% at March 31, 2019.

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  |
| **Allocation of allowance for loan losses:** |  |  |  |  |  |  |  |
| Individually evaluated for impairment - specific reserves |  | $ | 570 |  | $ | 615 |  |
| Collectively evaluated for impairment - general reserves |  |  | 15,123 |  |  | 11,862 |  |
| **Total** |  | $ | 15,693 |  | $ | 12,477 |  |

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 March 31, 2020, $570,000 of the Company’s ALL was allocated to impaired loans totaling approximately $10.4 million compared to $615,000 of the Company’s ALL allocated to impaired loans totaling approximately $7.4 million at December 31, 2019. Management determined that $5.4 million, or 53%, of total impaired loans required no reserve allocation at March 31, 2020 compared to $2.6 million, or 35%, at December 31, 2019, 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 of 2019, management adjusted the look-back period to begin with loss history in the first quarter 2012 as

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the starting point through the current quarter and it will continue to include this starting point going forward. At that time, Management determined that with the extended economic recovery then existing, the look-back period should be expanded to include the current economic cycle. The look-back period will then be adjusted once a sustained 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. 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.

As a result of rapidly increasing unemployment rates resulting from the COVID-19 virus, management determined that the first quarter 2020 allowance for loan loss economic qualitative adjustment should be temporarily adapted to utilize current published statistics rather than the lagging statistics that had been utilized historically. While these lagging indicators have been very reliable for some time, they do not accurately capture the risk that has been brought about by rapid changes in the economy. Based upon the change in the national unemployment rate available as of March 31, 2020, the economic qualitative adjustment was increased according to the Company's methodology to account for the uncertainty in economic conditions compared to the lookback period.  Management believes this temporary alteration will be a better indicator until the economy stabilizes and the true impact can be measured.

The more significant changes from December 31, 2019 to March 31, 2020 in the allocations of the allowance for loan losses to the loan portfolios listed above was primarily attributed to the additional economic qualitative factor adjustment resulting from the COVID-19 pandemic.

*Provision*

A $3.3 million ***provision for loan losses*** was required for the three months ended March 31, 2020 compared to a $150,000 provision for the three months ended March 31, 2019. In March of 2020, an additional $3.0 million was recorded during the quarter due to current economic conditions resulting from the COVID-19 pandemic.

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **Three Months Ended** | | | | |
|  |  | **March 31,** | | | | |
| *(In thousands)* |  | **2020** | |  | **2019** | |
| **Analysis of allowance for loan losses:** |  |  |  |  |  |  |
| Balance beginning of period |  | $ | 12,477 |  | $ | 11,652 |
| **Charge-offs:** |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  |  | 41 |  |  | 53 |
| Real estate construction - residential |  |  | — |  |  | — |
| Real estate construction - commercial |  |  | — |  |  | — |
| Real estate mortgage - residential |  |  | 19 |  |  | 84 |
| Real estate mortgage - commercial |  |  | 22 |  |  | 8 |
| Installment and other consumer |  |  | 52 |  |  | 52 |
| **Total charge-offs** |  |  | 134 |  |  | 197 |
| **Recoveries:** |  |  |  |  |  |  |
| Commercial, financial, and agricultural |  | $ | 25 |  | $ | 108 |
| Real estate construction - residential |  |  | — |  |  | — |
| Real estate construction - commercial |  |  | — |  |  | — |
| Real estate mortgage - residential |  |  | 9 |  |  | 99 |
| Real estate mortgage - commercial |  |  | 2 |  |  | — |
| Installment and other consumer |  |  | 14 |  |  | 33 |
| **Total recoveries** |  |  | 50 |  |  | 240 |
| **Net charge-offs** |  |  | **84** |  |  | **(43)** |
| Provision for loan losses |  |  | 3,300 |  |  | 150 |
| **Balance end of period** |  | $ | 15,693 |  | $ | 11,845 |

*Net Loan Charge-offs*

The Company’s net charge-offs were $84,000, or 0.01% of average loans, for the three months ended March 31, 2020 compared to net recoveries of $43,000, or 0.00% of average loans, for the three months ended March 31, 2019. The increase in net charge-offs for the three months ended March 31, 2020 compared to the three months ended March 31, 2019 was primarily related to one commercial loan relationship recovery and one real estate mortgage – residential recovery received during the first quarter of 2019.

*Loans Held For Sale*

The Company designates certain long-term fixed rate personal real estate loans as held for sale, and the Company carries them at the lower of cost or fair value. The loans are primarily sold to Freddie Mac, Fannie Mae, and PennyMac. At March 31, 2020, the carrying amount of these loans was $4.3 million.

In the fourth quarter of 2019 the Company expanded its current home loan program to better serve our customers. This expansion began with hiring new mortgage lending personnel and expanding the bank’s available loan products and upgrading the Company's operating systems. New home loan programs for its customers include VA loans, designed for military families and veterans; USDA loans for those buying homes in rural communities; and FHA loans, which offer low down payments and flexible underwriting guidelines. In addition, we have added several secondary market investors, allowing us to sell loans on the secondary market versus servicing them at the Company. This provides us with the ability to offer clients more aggressive pricing and improve our bottom line.

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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.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  |
| Federal funds sold and other overnight interest-bearing deposits |  | $ | 58,619 |  | $ | 55,545 |  |
| Certificates of deposit in other banks |  |  | 11,106 |  |  | 10,862 |  |
| Available-for-sale investment securities |  |  | 198,049 |  |  | 175,093 |  |
| **Total** |  | $ | 267,774 |  | $ | 241,500 |  |

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 $198.0 million at March 31, 2020 and included an unrealized net gain of $2.7 million. The portfolio includes projected maturities and mortgage backed securities pay-downs of approximately $13.4 million over the next twelve months, which offer resources to meet either new loan demand or reductions in the Company’s deposit base.

The Company pledges portions of its investment securities portfolio to secure public fund deposits, federal funds purchase lines, securities sold under agreements to repurchase, borrowing capacity at the Federal Reserve Bank, and for other purposes required by law. At March 31, 2020 and December 31, 2019, the Company’s unpledged securities in the available for sale portfolio totaled approximately $48.3 million and $35.3 million, respectively.

Total investment securities pledged for these purposes were as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |
| *(In thousands)* |  | **2020** | |  | **2019** | |
| **Investment securities pledged for the purpose of securing:** |  |  |  |  |  |  |
| Federal Reserve Bank borrowings |  | $ | 9,521 |  | $ | 9,385 |
| Federal funds purchased and securities sold under agreements to repurchase |  |  | 41,047 |  |  | 38,238 |
| Other deposits |  |  | 99,193 |  |  | 92,189 |
| **Total pledged, at fair value** |  | $ | 149,761 |  | $ | 139,812 |

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 March 31, 2020, such deposits totaled $1.0 billion and represented 86.3% 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 March 31, 2020 and December 31, 2019 were as follows:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  |
| **Core deposit base:** |  |  |  |  |  |  |  |
| Non-interest bearing demand |  | $ | 272,578 |  | $ | 261,166 |  |
| Interest checking |  |  | 202,213 |  |  | 227,662 |  |
| Savings and money market |  |  | 353,936 |  |  | 346,593 |  |
| Other time deposits |  |  | 189,497 |  |  | 197,089 |  |
| **Total** |  | $ | 1,018,224 |  | $ | 1,032,510 |  |

Time deposits and certificates of deposit of $250,000 and greater at March 31, 2020 and December 31, 2019 were $111.8 million and $104.3 million, respectively. The Company had brokered deposits totaling $42.6 million and $45.2 million at March 31, 2020 and December 31, 2019, 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 March 31, 2020, under agreements with these unaffiliated banks, the Bank may borrow up to $50.0 million in federal funds on an unsecured basis and $15.9 million on a secured basis. There were no federal funds purchased outstanding at March 31, 2020. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of the Company’s investment portfolio. At March 31, 2020, there were $30.8 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 March 31, 2020.

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 March 31, 2020, the Bank had $133.8 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 March 31, 2020 and December 31, 2019 were as follows:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **March 31,** | |  | **December 31,** | |  |
| *(In thousands)* |  | **2020** | |  | **2019** | |  |
| **Borrowings:** |  |  |  |  |  |  |  |
| Federal funds purchased and securities sold under agreements to repurchase |  | $ | 30,764 |  | $ | 27,272 |  |
| Federal Home Loan Bank advances |  |  | 133,837 |  |  | 96,895 |  |
| Subordinated notes |  |  | 49,486 |  |  | 49,486 |  |
| Other borrowings |  |  | 24 |  |  | 24 |  |
| **Total** |  | $ | 214,111 |  | $ | 173,677 |  |

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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|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **March 31,** | | | | | | | | | | |  | **December 31,** | | | | | | | | | | |
|  |  | **2020** | | | | | | | | | | |  | **2019** | | | | | | | | | | |
|  |  |  |  |  |  |  |  | **Federal** | |  |  |  |  |  |  |  |  |  |  | **Federal** | |  |  |  |
|  |  |  |  |  |  |  |  | **Funds** | |  |  |  |  |  |  |  |  |  |  | **Funds** | |  |  |  |
|  |  |  |  |  | **Federal** | |  | **Purchased** | |  |  |  |  |  |  |  | **Federal** | |  | **Purchased** | |  |  |  |
| *(In thousands)* |  | **FHLB** | |  | **Reserve Bank** | |  | **Lines** | |  | **Total** | |  | **FHLB** | |  | **Reserve Bank** | |  | **Lines** | |  | **Total** | |
| Advance equivalent |  | $ | 281,998 |  | $ | 9,296 |  | $ | 56,584 |  | $ | 347,878 |  | $ | 284,813 |  | $ | 9,190 |  | $ | 56,839 |  | $ | 350,842 |
| Letters of credit |  |  | (81,000) |  |  | — |  |  | — |  |  | (81,000) |  |  | (115,000) |  |  | — |  |  | — |  |  | (115,000) |
| Advances outstanding |  |  | (133,837) |  |  | — |  |  | — |  |  | (133,837) |  |  | (96,895) |  |  | — |  |  | — |  |  | (96,895) |
| **Total available** |  | $ | 67,161 |  | $ | 9,296 |  | $ | 56,584 |  | $ | 133,041 |  | $ | 72,918 |  | $ | 9,190 |  | $ | 56,839 |  | $ | 138,947 |

At March 31, 2020, loans of $510.3 million were pledged at the Federal Home Loan Bank as collateral for borrowings and letters of credit. At March 31, 2020, investments totaling $18.1 million were pledged to secure federal funds purchase lines and borrowing capacity at the Federal Reserve Bank.

Based upon the above, management believes the Company has more than adequate liquidity, both on balance sheet and through the additional funding capacity with the FHLB, the Federal Reserve Bank and Federal funds purchased lines to meet future anticipated needs. This includes the impact of the COVID-19 pandemic that is difficult to currently measure.  Management believes the most significant impact to the Company’s liquidity position will be short-term as the SBA PPP loans are expected to be forgiven by the SBA and mostly paid off within the next two to three months. In addition, loan modifications are generally for two to three months at which time resumption of regular payments is generally expected.   The longer-term impact on the Company’s liquidity from the pandemic will be closely monitored and addressed as the need arises.

The Company also has available additional liquidity by pledging the PPP loans to either the FHLB or the Federal Reserve as collateral for available advances under their respective lending facilities.

**Sources and Uses of Funds**

Cash and cash equivalents were $75.3 million at March 31, 2020 compared to $78.1 million at December 31, 2019. The $2.8 million decrease resulted from changes in the various cash flows produced by operating, investing, and financing activities of the Company, as shown in the accompanying consolidated statement of cash flows for the three months ended March 31, 2020. Cash outflow used in operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities used total cash of $542,000 for the three months ended March 31, 2020.

Investing activities consisting mainly of purchases, sales and maturities of available-for-sale securities, and changes in the level of the loan portfolio used total cash of $34.3 million. The cash outflow primarily consisted of $44.0 million purchase of investment securities and $11.8 million increase in loans, partially offset by $23.5 million from maturities, calls, and sales of investment securities.

Financing activities provided cash of $32.0 million, resulting primarily from a $37.0 million increase in net FHLB advances, and an $11.4 million increase in demand deposits, partially offset by an $18.0 million decrease in interest bearing transaction accounts. Future short-term liquidity needs arising from daily operations are not expected to vary significantly during 2020.

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 $362.7 million in unused loan commitments and standby letters of credit as of March 31, 2020. 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

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dividends to its shareholders. The Company paid cash dividends to its shareholders totaling approximately $753,000 and $603,000 for the three months ended March 31, 2020 and 2019, respectively. A large portion of the Company’s liquidity is obtained from the Bank in the form of dividends. The Bank did not declare or pay dividends during the three months ended March 31, 2020, and declared and paid $1.5 million in dividends to the Company during the three months ended March 31, 2019. At March 31, 2020 and December 31, 2019, the Company had cash and cash equivalents totaling $781,000 and $2.6 million, respectively.

**Capital Management**

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

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

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. Institutions that do not maintain the required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management.  The capital conservation buffer requirement began being phased in over four years beginning in 2016. On January 1, 2016, the first phase of the requirement went into effect at 0.625% of risk-weighted assets, and increased each subsequent year by an additional 0.625 percentage points, to reach its final level of 2.5% of risk weighted assets on January 1, 2019. At December 31, 2019, the capital conservation buffer of 2.5%, effectively raised 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.

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Under the Basel III requirements, at March 31, 2020 and December 31, 2019, 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:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  | **Minimum Capital** | | | |  | **Required to be** | | | |  |
|  |  |  |  |  |  |  | **Required - Basel III** | | | |  | **Considered Well-** | | | |  |
|  |  | **Actual** | | | |  | **Fully Phased-In \*** | | | |  | **Capitalized** | | | |  |
| ***(in thousands)*** |  | **Amount** | |  | **Ratio** |  | **Amount** | |  | **Ratio** |  | **Amount** | |  | **Ratio** |  |
| **March 31, 2020** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Total Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 181,453 |  | 14.80 | % | $ | 128,756 |  | 10.50 | % | $ | — |  | N.A | % |
| Bank |  |  | 179,656 |  | 14.73 |  |  | 128,076 |  | 10.50 |  |  | 121,977 |  | 10.00 |  |
| **Tier 1 Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 157,082 |  | 12.81 | % | $ | 104,231 |  | 8.50 | % | $ | — |  | N.A | % |
| Bank |  |  | 164,395 |  | 13.48 |  |  | 103,680 |  | 8.50 |  |  | 97,582 |  | 8.00 |  |
| **Common Equity Tier 1 Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 118,192 |  | 9.64 | % | $ | 85,837 |  | 7.00 | % | $ | — |  | N.A | % |
| Bank |  |  | 164,395 |  | 13.48 |  |  | 85,384 |  | 7.00 |  |  | 79,285 |  | 6.50 |  |
| **Tier 1 leverage ratio (to adjusted average assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 157,082 |  | 10.43 | % | $ | 60,250 |  | 4.00 | % | $ | — |  | N.A | % |
| Bank |  |  | 164,395 |  | 10.98 |  |  | 59,886 |  | 4.00 |  |  | 74,857 |  | 5.00 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **December 31, 2019** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Total Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 179,430 |  | 14.89 | % | $ | 126,511 |  | 10.50 | % | $ | — |  | N.A | % |
| Bank |  |  | 175,459 |  | 14.60 |  |  | 126,165 |  | 10.50 |  |  | 120,158 |  | 10.00 |  |
| **Tier 1 Capital (to risk-weighted assets):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 157,139 |  | 13.04 | % | $ | 102,414 |  | 8.50 | % | $ | — |  | N.A | % |
| Bank |  |  | 162,822 |  | 13.55 |  |  | 102,134 |  | 8.50 |  |  | 96,126 |  | 8.00 |  |
| **Common Equity Tier 1 Capital (to risk-weighted assets)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 118,793 |  | 9.86 | % | $ | 84,341 |  | 7.00 | % | $ | — |  | N.A | % |
| Bank |  |  | 162,822 |  | 13.55 |  |  | 84,110 |  | 7.00 |  |  | 78,102 |  | 6.50 |  |
| **Tier 1 leverage ratio:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Company |  | $ | 157,139 |  | 10.73 | % | $ | 58,562 |  | 4.00 | % | $ | — |  | N.A | % |
| Bank |  |  | 162,822 |  | 11.18 |  |  | 58,280 |  | 4.00 |  |  | 72,850 |  | 5.00 |  |

**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 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

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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 March 31, 2020 and December 31, 2019.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |
|  |  | **% Change in projected net interest income** | | | | | |
| **Hypothetical shift in interest rates** |  | **March 31,** | | | | | |
| ***(bps)*** |  | **2020** | |  | **2019** | |  |
| 200 |  |  | (1.33) | % |  | 2.93 | % |
| 100 |  |  | (1.01) | % |  | 2.90 | % |
| (100) |  |  | (1.97) | % |  | 2.76 | % |
| (200) |  |  | (2.99) | % |  | 2.13 | % |

The change in our interest rate risk exposure from March 31, 2019 to March 31, 2020 was primarily due to the significant decrease in market rates over this time period that has caused offering rates for earning assets to decrease more than offering rates for interest-bearing liabilities. In addition, our federal funds sold position has decreased from the prior year quarter-end and the amount of variable rate loans that are at their floor interest rate levels has increased. These factors have caused the Company’s balance sheet to become slightly liability sensitive in the next 12 months and due to the smaller amount of loans that will reprice with a change in rates the projected amount of net interest income has decreased in all interest rate scenarios. In addition, due to the low level of market interest rates at March 31, 2020, funding rates can only drop to zero while earning asset rates are at levels that allow for additional decreases which causes net interest income to decrease more in a falling rate environment. Management believes the change in projected net interest income from interest rate shifts of up 200 bps and down 200 bps is an acceptable 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.

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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 March 31, 2020.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

Our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended) are designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission and to ensure that information required to be disclosed is accumulated and communicated to management, including our principal executive and financial officers, to allow timely decisions regarding disclosure. The Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), with assistance from other members of management, have reviewed the effectiveness of our disclosure controls and procedures as of May 7, 2020 and, based on their evaluation, have concluded the disclosure controls and procedures were not effective as of that date due to a material weakness in internal control over financial reporting that was disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2019.

**Changes in Internal Control Over Financial Reporting**

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) of the Exchange Act) that occurred during the three months ending March 31, 2020 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

**Remediation**

As previously described in Part II, Item 9A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2019, we began implementing a remediation plan to address the material weakness mentioned above. The material weakness will not be considered remediated, until the applicable controls operate for a sufficient period of time and management has concluded, through testing, that these controls are operating effectively. We expect that the remediation of this material weakness will be completed prior to the end of fiscal 2020.

**Impact of New Accounting Standards**

***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.

***Financial Instruments*** In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses* *(Topic 326):* *Measurement of Credit Losses on Financial Instruments* (CECL)*.* The revised accounting guidance will remove all recognition thresholds and will require a company to recognize an allowance for credit losses for the difference between the amortized cost basis of a financial instrument and the amount of amortized cost that the company expects to collect over the instrument's contractual life. It also amends the credit loss measurement guidance for available-for-sale debt securities and beneficial interests in securitized financial assets. This new accounting guidance will be effective for interim and annual reporting periods beginning after December 15, 2022. 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 January 1, 2023.

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***Rate Reform*** In March 2020, the FASB issued ASU 2020-04, *Reference Rate Reform (Topic 848)  - Facilitation of the Effects of Reference Rate Reform on Financial Reporting*. The amendments in this update provide optional guidance for a limited period of time to ease the potential burden in accounting for (or recognizing the effects of) reference rate reform on financial reporting. It provides optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships, subject to meeting certain criteria, that reference LIBOR or another reference rate expected to be discontinued. The amendments in this update are effective for all entities as of March 12, 2020 through December 31, 2022. The Company is currently evaluating the impact of the reference rate reform on the Company’s consolidated financial statements.

**PART II - OTHER INFORMATION**

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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

In addition to the risk factors set forth under Part I, Item 1A “Risk Factors” in the Company’s Form 10-K for the fiscal year ended December 31, 2019, the following risk factor applies to the Company.

The outbreak of Coronavirus Disease 2019 (“COVID-19”) has adversely impacted, or an outbreak of other highly infectious or contagious diseases could adversely impact certain industries in which the Company’s customers operate and impair their ability to fulfill their obligations to the Company. Further, the spread of the outbreak could lead to an economic recession or other severe disruptions in the U.S. economy and may disrupt banking and other financial activity in the areas in which the Company operates and could potentially create widespread business continuity issues for the Company.

The spread of highly infectious or contagious diseases could cause, and the spread of COVID-19 has caused, severe disruptions in the U.S. economy at large, and for small businesses in particular, which could disrupt the Company’s operations. We are starting to see the impact from COVID-19 on our business, and we believe that it will be significant, adverse and potentially material. Currently, COVID-19 is spreading through the United States and the world. The resulting concerns on the part of the U.S. and global population have created the threat of a recession, reduced economic activity and a significant correction in the global stock markets. We expect that we will experience significant disruption across our business due to these effects, leading to decreased earnings, significant slowdowns in our loan collections and loan defaults.

COVID-19 may impact businesses’ and consumers’ desire and willingness to borrow money, which would negatively impact loan volumes. In addition, certain of our borrowers are in or have exposure to the hospitality, restaurant, gaming, and long-term health care industries and/or are located in areas that are quarantined or under stay-at-home orders, and COVID-19 may also have an adverse effect on our commercial real estate, and consumer loan portfolios. A prolonged quarantine or stay-at-home order would have a negative adverse impact on these borrowers and their revenue streams, which consequently impacts their ability to meet their financial obligations and could result in loan defaults.

The outbreak of COVID-19 or an outbreak of other highly infectious or contagious diseases may result in a decrease in our customers’ businesses, a decrease in consumer confidence and business generally, an increase in unemployment or a disruption in the services provided by the Company’s vendors. Disruptions to our customers could result in increased risk of delinquencies, defaults, foreclosures and losses on our loans, declines in assets under management and wealth management revenues, negatively impact regional economic conditions, result in declines in local loan demand, liquidity

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of loan guarantors, loan collateral (particularly in real estate), loan originations and deposit availability and negatively impact the implementation of our growth strategy.

The Company relies upon its third-party vendors to conduct business and to process, record, and monitor transactions. If any of these vendors are unable to continue to provide the Company with these services, it could negatively impact the Company’s ability to serve its customers. Furthermore, the outbreak could negatively impact the ability of the Company’s employees and customers to engage in banking and other financial transactions in the geographic areas in which the Company operates and could create widespread business continuity issues for the Company. The Company also could be adversely affected if key personnel or a significant number of employees were to become unavailable due to the effects and restrictions of a COVID-19 outbreak in our market areas. Although the Company has business continuity plans and other safeguards in place, there is no assurance that such plans and safeguards will be effective.

Management believes that the economic impact from COVID-19 will be severe and could have a material and adverse impact on our business and that it could result in significant losses in our loan portfolio, all of which would adversely and materially impact our earnings and capital.

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

The following table summarizes the purchases made by or on behalf of the Company or certain affiliated purchasers of shares of the Company's common stock during the three months ended March 31, 2020:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
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|  | | |  |  |  |  |  |  |  |  |  |  |  | |
|  | | |  |  |  |  |  |  |  |  |  | **(d) Maximum Number (or** | | |
|  | | |  |  |  |  |  |  |  | **(c) Total Number of** |  | **Approximate Dollar** | | |
|  | | |  |  |  |  |  |  |  | **Shares (or Units)** |  | **Value) of Shares (or** | | |
|  | | |  |  | **(a) Total Number of** |  | **(b) Average Price** | |  | **Purchased as Part of** |  | **Units) that May Yet Be** | | |
|  | | |  |  | **Shares (or Units)** |  | **Paid per Share (or** | |  | **Publicly Announced Plans** |  | **Purchased Under the** | | |
| **Period** | | |  |  | **Purchased** |  | **Unit)** | |  | **or Programs** |  | **Plans or Programs \*** | | |
|  | | |  |  |  |  |  |  |  |  |  | $ | 5,000,000 | |
| January 1-31, 2020 | | |  |  | 700 |  | $ | 22.93 |  | 700 |  | $ | 4,983,950 | |
| February 1-29, 2020 | | |  |  | 9,830 |  | $ | 22.67 |  | 9,830 |  | $ | 4,761,080 | |
| March 1-31, 2020 | | |  |  | 24,404 |  | $ | 19.68 |  | 24,404 |  | $ | 4,280,792 | |
| Total | | |  |  | 34,934 |  | $ | 20.59 |  | 34,934 |  | $ | 4,280,792 | |
|  |  |  | | | | | | | | | | | |  |
|  |  |  | | | | | | | | | | | | |
|  |  | \* 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. | | | | | | | | | | | |  |
| Item 3. |  | Defaults Upon Senior Securities | | | | | | | | | | | | None |
|  |  |  | | | | | | | | | | | |  |
| Item 4. |  | Mine Safety Disclosures | | | | | | | | | | | | None |
|  |  |  | | | | | | | | | | | |  |
| Item 5. |  | Other Information | | | | | | | | | | | | None |
|  |  |  | | | | | | | | | | | |  |
| Item 6. |  | Exhibits | | | | | | | | | | | |  |

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| **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-20200331ex3112d912f.htm) |
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| 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-20200331ex3219b2e33.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-20200331ex322265dad.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

March 31, 2020 Form 10‑Q

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

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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 |
|  |  |
| May 7, 2020 | David T. Turner, Chairman of the Board and |
|  | Chief Executive Officer (Principal Executive Officer) |
|  |  |
|  | /s/ W. Bruce Phelps |
|  |  |
| May 7, 2020 | W. Bruce Phelps, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) |
|  |  |

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