HAWTHORN BANCSHARES, INC.
Form 10-Q
May 15, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2014

or

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

For the transition period from to

Commission File Number: 0-23636

HAWTHORN BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

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

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

(Address of principal executive offices) (Zip Code)

(573) 761-6100

(Registrant s telephone number, including area code)

N/A

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

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

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

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

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

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

As of May 15, 2014, the registrant had 5,032,679 shares of common stock, par value $1.00 per share, outstanding

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets *(unaudited)*

(In thousands, except per share data)

	March 31, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$ 24,314	$ 27,079
Federal funds sold and other overnight interest-bearing deposits	16,920	1,360
Cash and cash equivalents	41,234	28,439
Investment in available-for-sale securities, at fair value	213,227	205,985
Loans	845,307	839,547
Allowances for loan losses	(12,845)	(13,719)
Net loans	832,462	825,828
Premises and equipment - net	38,164	38,079
Investments in Federal Home Loan Bank stock and other equity securities, at cost	3,962	4,001
Mortgage servicing rights	3,040	3,036
Other real estate owned and repossessed assets - net	14,054	14,867
Accrued interest receivable	4,441	4,999
Cash surrender value - life insurance	2,233	2,213
Other assets	12,152	12,675
Total assets	$ 1,164,969	$ 1,140,122
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits		
Non-interest bearing demand	$ 189,925	$ 187,382
Savings, interest checking and money market	453,724	419,085
Time deposits $100,000 and over	110,045	111,667
Other time deposits	234,042	238,337
Total deposits	987,736	956,471
Federal funds purchased and securities sold under agreements to repurchase	20,761	31,084
Subordinated notes	49,486	49,486
Federal Home Loan Bank advances	24,000	24,000
Accrued interest payable	412	426
Other liabilities	5,892	4,275
Total liabilities	1,088,287	1,065,742
Stockholders equity:		
Common stock, $1 par value, authorized 15,000,000 shares; issued 5,194,537 shares, respectively	5,195	5,195
Surplus	33,391	33,385
Retained earnings	41,821	40,086
Accumulated other comprehensive loss, net of tax	(208)	(769)
Treasury stock; 161,858 shares, at cost	(3,517)	(3,517)
Total stockholders equity	76,682	74,380
Total liabilities and stockholders equity	$ 1,164,969	$ 1,140,122

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Operations *(unaudited)*

(In thousands, except per share amounts)		**Three Months Ended March 31, 2014**		**2013**
INTEREST INCOME				
Interest and fees on loans	$	9,865	$	10,387
Interest on investment securities:				
Taxable		881		905
Nontaxable		189		217
Federal funds sold and other overnight interest-bearing deposits		8		14
Dividends on other securities		20		22
Total interest income		10,963		11,545
INTEREST EXPENSE				
Interest on deposits:				
Savings, interest checking and money market		267		261
Time deposit accounts $100,000 and over		190		248
Other time deposits		432		883
Interest on federal funds purchased and securities sold under agreements to repurchase		4		5
Interest on subordinated notes		312		320
Interest on Federal Home Loan Bank advances		104		99
Total interest expense		1,309		1,816
Net interest income		9,654		9,729
Provision for loan losses		0		1,000
Net interest income after provision for loan losses		9,654		8,729
NON-INTEREST INCOME				
Service charges on deposit accounts		1,230		1,359
Trust department income		203		210
Real estate servicing fees, net		177		159
Gain on sale of mortgage loans, net		191		720
Gain on sale of investment securities		0		294
Other		284		265
Total non-interest income		2,085		3,007
NON-INTEREST EXPENSE				
Salaries and employee benefits		5,030		4,910
Occupancy expense, net		620		635
Furniture and equipment expense		443		435
FDIC insurance assessment		238		243
Legal, examination, and professional fees		226		226
Advertising and promotion		290		281
Postage, printing, and supplies		265		256
Processing expense		759		1,275
Other real estate expense, net		124		2,821
Other		712		852
Total non-interest expense		8,707		11,934
Income (loss) before income taxes		3,032		(198)
Income tax expense (benefit)		1,045		(62)
Net income (loss)		1,987		(136)
Preferred stock dividends and accretion of discount		0		295
Net income (loss) available to common shareholders	$	1,987	$	(431)
Basic earnings (loss) per share	$	0.39	$	(0.09)
Diluted earnings (loss) per share	$	0.39	$	(0.09)

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

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

	Three Months Ended March 31,			
(In thousands)		**2014**		**2013**
Net income (loss)	$	1,987	$	(136)
Other comprehensive income (loss), net of tax				
Investment securities available-for-sale:				
Unrealized gain (loss) on investment securities available-for-sale, net of tax		549		(540)
Adjustment for gain on sale of investment securities, net of tax		0		(182)
Defined benefit pension plans:				
Amortization of prior service cost included in net periodic pension cost, net of tax		12		16
Total other comprehensive income (loss)		561		(706)
Total comprehensive income (loss)	$	2,548	$	(842)

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity *(unaudited)*

(In thousands)	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stock - holders Equity
Balance, December 31, 2012	$ 17,977	$ 5,001	$ 31,816	$ 39,118	$ 1,825	$ (3,517)	$ 92,220
Net loss	0	0	0	(136)	0	0	(136)
Other comprehensive loss	0	0	0	0	(706)	0	(706)
Stock based compensation expense	0	0	2	0	0	0	2
Accretion of preferred stock discount	72	0	0	(72)	0	0	0
Cash dividends declared, preferred stock	0	0	0	(228)	0	0	(228)
Cash dividends declared, common stock	0	0	0	(242)	0	0	(242)
Balance, March 31, 2013	$ 18,049	$ 5,001	$ 31,818	$ 38,440	$ 1,119	$ (3,517)	$ 90,910
Balance, December 31, 2013	$ 0	$ 5,195	$ 33,385	$ 40,086	$ (769)	$ (3,517)	$ 74,380
Net income	0	0	0	1,987	0	0	1,987
Other comprehensive income	0	0	0	0	561	0	561
Stock based compensation expense	0	0	6	0	0	0	6
Cash dividends declared, common stock	0	0	0	(252)	0	0	(252)
Balance, March 31, 2014	$ 0	$ 5,195	$ 33,391	$ 41,821	$ (208)	$ (3,517)	$ 76,682

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows *(unaudited)*

(In thousands)	**Three Months Ended March 31, 2014**	**2013**
Cash flows from operating activities:		
Net income (loss)	$ 1,987	$ (136)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	0	1,000
Depreciation expense	422	400
Net amortization of investment securities, premiums, and discounts	250	343
Amortization of intangible assets	0	101
Stock based compensation expense	6	2
Change in fair value of mortgage servicing rights	46	57
Gain on sale of investment securities	0	(294)
Gain on sales and dispositions of premises and equipment	(13)	0
Gain on sales and dispositions of other real estate owned and repossessed assets	(145)	(13)
Provision for other real estate owned	123	2,343
Decrease in accrued interest receivable	558	167
Increase in cash surrender value -life insurance	(20)	(21)
Decrease (increase) in other assets	199	(476)
(Decrease) increase in accrued interest payable	(14)	125
Increase in other liabilities	1,616	800
Origination of mortgage loans for sale	(5,811)	(26,463)
Proceeds from the sale of mortgage loans	5,974	29,290
Gain on sale of mortgage loans, net	(191)	(720)
Other, net	(50)	(170)
Net cash provided by operating activities	4,937	6,335
Cash flows from investing activities:		
Net (increase) decrease in loans	(6,865)	6,854
Purchase of available-for-sale debt securities	(24,038)	(62,541)
Proceeds from maturities of available-for-sale debt securities	5,687	11,260
Proceeds from calls of available-for-sale debt securities	11,745	2,255
Proceeds from sales of available-for-sale debt securities	0	15,981
Proceeds from sales of FHLB stock	39	2
Purchases of premises and equipment	(507)	(326)
Proceeds from sales of premises and equipment	13	0
Proceeds from sales of other real estate owned and repossessed assets	1,094	604
Net cash used in investing activities	(12,832)	(25,911)
Cash flows from financing activities:		
Net increase (decrease) in demand deposits	2,543	(14,866)
Net increase in interest-bearing transaction accounts	34,639	33,942
Net decrease in time deposits	(5,917)	(10,471)
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(10,323)	(3,519)
Repayment of FHLB advances	(10,000)	(55)
FHLB advances	10,000	0
Cash dividends paid - preferred stock	0	(228)
Cash dividends paid - common stock	(252)	(242)
Net cash provided by financing activities	20,690	4,561
Net increase (decrease) in cash and cash equivalents	12,795	(15,015)
Cash and cash equivalents, beginning of period	28,439	58,887
Cash and cash equivalents, end of period	$ 41,234	$ 43,872

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

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

(In thousands)	**Three Months Ended March 31, 2014**			**2013**
Supplemental disclosures of cash flow information:				
Cash paid during the year for:				
Interest	$	1,324	$	1,624
Income taxes	$	0	$	6
Supplemental schedule of noncash investing and financing activities:				
Other real estate and repossessions acquired in settlement of loans	$	259	$	2,470

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC.

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Notes to the Consolidated Financial Statements

(Unaudited)

(1) Summary of Significant Accounting Policies

Hawthorn Bancshares, Inc. (the Company) through its subsidiary, Hawthorn Bank (the Bank), provides a broad range of banking services to individual and corporate customers located within the communities in and surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson, and Lee s Summit, Missouri. 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, 2013.

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

Stock Dividend On July 1, 2013, the Company paid a special stock dividend of four percent to shareholders of record at the close of business on June 15, 2013. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

Preferred Stock On December 19, 2008, the Company announced its participation in the U.S. Treasury Department s Capital Purchase Program (CPP), a voluntary program that provides capital to financially healthy banks. Participation in this program included the Company s issuance of 30,255 shares of senior preferred stock (with a par value of $1,000 per share) and a ten year warrant to purchase approximately 287,133 shares of common stock. On May 9, 2012, the Company redeemed 12,000 of the 30,255 shares of preferred stock issued under the U.S. Treasury s CPP program, and on May 15, 2013, the remaining 18,255 shares were redeemed.

On June 11, 2013, the common stock warrant issued under the U.S. Treasury Department s CPP program was repurchased by the Company pursuant to a letter agreement between the Treasury and the Company for a total repurchase price of $540,000, or $1.88 per warrant share. The repurchase price was based on the fair market value of the warrant as agreed upon by the Company and the Treasury. The repurchase of the warrant ends the Company s participation in the U.S. Treasury Department s CPP.

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(2) Loans and Allowance for Loan Losses

Loans

A summary of loans, by major class within the Company s loan portfolio, at March 31, 2014 and December 31, 2013 is as follows:

(in thousands)	March 31, 2014	December 31, 2013
Commercial, financial, and agricultural	$ 132,346	$ 133,717
Real estate construction - residential	22,060	21,008
Real estate construction - commercial	57,340	55,076
Real estate mortgage - residential	230,310	225,541
Real estate mortgage - commercial	384,130	382,550
Installment and other consumer	19,121	21,655
Total loans	$ 845,307	$ 839,547

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the communities surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee s Summit, Missouri. 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, 2014, loans with a carrying value of $376.9 million were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit.

Allowance for Loan Losses

The following is a summary of the allowance for loan losses for the three months ended March 31, 2014 and 2013:

(in thousands)	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
Balance at December 31, 2013	**$ 2,374**	**$ 931**	**$ 631**	**$ 2,959**	**$ 6,523**	**$ 294**	**$ 7**	**$ 13,719**
Additions:								
Provision for loan losses	93	(392)	333	139	(153)	(13)	(7)	0
Deductions:								
Loans charged off	131	60	414	120	367	84	0	1,176
Less recoveries on loans	(116)	0	0	(112)	(16)	(58)	0	(302)
Net loans charged off	15	60	414	8	351	26	0	874
Balance at March 31, 2014	**$ 2,452**	**$ 479**	**$ 550**	**$ 3,090**	**$ 6,019**	**$ 255**	**$ 0**	**$ 12,845**
Balance at December 31, 2012	**$ 1,937**	**$ 732**	**$ 1,711**	**$ 3,387**	**$ 6,834**	**$ 239**	**$ 2**	**$ 14,842**
Additions:								
Provision for loan losses	(90)	287	100	(189)	844	47	1	1,000
Deductions:								
Loans charged off	61	120	0	292	999	109	0	1,581
Less recoveries on loans	(42)	0	0	(15)	(161)	(66)	0	(284)
Net loans charged off	19	120	0	277	838	43	0	1,297
Balance at March 31, 2013	**$ 1,828**	**$ 899**	**$ 1,811**	**$ 2,921**	**$ 6,840**	**$ 243**	**$ 3**	**$ 14,545**

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

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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.

The following table provides the balance in the allowance for loan losses at March 31, 2014 and December 31, 2013, and the related loan balance by impairment methodology.

(in thousands)	Commercial, Financial, and Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment Loans to Individuals	Un-allocated	Total
March 31, 2014								
Allowance for loan losses:								
Individually evaluated for impairment	$ 1,069	$ 307	$ 36	$ 1,808	$ 1,482	$ 51	$ 0	$ 4,753
Collectively evaluated for impairment	1,383	172	514	1,282	4,537	204	0	8,092
Total	**$ 2,452**	**$ 479**	**$ 550**	**$ 3,090**	**$ 6,019**	**$ 255**	**$ 0**	**$ 12,845**
Loans outstanding:								
Individually evaluated for impairment	$ 4,919	$ 2,143	$ 5,936	$ 7,472	$ 15,252	$ 316	$ 0	$ 36,038
Collectively evaluated for impairment	127,427	19,917	51,404	222,838	368,878	18,805	0	809,269
Total	**$ 132,346**	**$ 22,060**	**$ 57,340**	**$ 230,310**	**$ 384,130**	**$ 19,121**	**$ 0**	**$ 845,307**
December 31, 2013								
Allowance for loan losses:								
Individually evaluated for impairment	$ 721	$ 392	$ 304	$ 1,374	$ 1,989	$ 16	$ 0	$ 4,796
Collectively evaluated for impairment	1,653	539	327	1,585	4,534	278	7	8,923
Total	**$ 2,374**	**$ 931**	**$ 631**	**$ 2,959**	**$ 6,523**	**$ 294**	**$ 7**	**$ 13,719**
Loans outstanding:								
Individually evaluated for	$ 4,015	$ 2,204	$ 6,615	$ 6,517	$ 15,422	$ 43	$ 0	$ 34,816

impairment															
Collectively evaluated for impairment		129,702		18,804		48,461		219,024		367,128		21,612		0	804,731
Total	**$**	**133,717**	**$**	**21,008**	**$**	**55,076**	**$**	**225,541**	**$**	**382,550**	**$**	**21,655**	**$**	**0**	**$ 839,547**

Impaired Loans

Loans evaluated under the Financial Accounting Standards Board s (FASB) Accounting Standards Update (ASU) 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 totaled $36.0 million and $35.1 million at March 31, 2014 and December 31, 2013, respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings. Total impaired loans of $36.0 million at March 31, 2014 were individually evaluated for impairment compared to $34.8 million of impaired loans individually evaluated for impairment and $259,000 of non-accrual consumer loans that were collectively evaluated for impairment at December 31, 2013. Beginning in 2014, consumer non-accrual loans were included the individually evaluated impairment calculations.

The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At March 31, 2014 and December 31, 2013, $32.7 million and $21.8 million, respectively, of impaired loans were evaluated based on the fair value of the loan s

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collateral. Once the impairment amount is calculated, a specific reserve allocation is recorded. At March 31, 2014, $4.8 million of the Company s allowance for loan losses was allocated to impaired loans totaling $36.0 million compared to $4.8 million of the Company s allowance for loan losses allocated to impaired loans totaling approximately $35.1 million at December 31, 2013. Management determined that $21.3 million, or 59%, of total impaired loans required no reserve allocation at March 31, 2014 compared to $18.8 million, or 54%, at December 31, 2013 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

The categories of impaired loans at March 31, 2014 and December 31, 2013 are as follows:

(in thousands)		March 31, 2014		December 31, 2013
Non-accrual loans	$	24,804	$	23,680
Troubled debt restructurings continuing to accrue interest		11,234		11,395
Total impaired loans	$	36,038	$	35,075

The following tables provide additional information about impaired loans at March 31, 2014 and December 31, 2013, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided.

(in thousands)		Recorded Investment		Unpaid Principal Balance		Specific Reserves
March 31, 2014						
With no related allowance recorded:						
Commercial, financial and agricultural	$	2,182	$	2,239	$	0
Real estate - construction residential		43		77		0
Real estate - construction commercial		5,833		6,998		0
Real estate - residential		2,105		2,814		0
Real estate - commercial		11,155		11,417		0
Total	$	21,318	$	23,545	$	0
With an allowance recorded:						
Commercial, financial and agricultural	$	2,737	$	2,800	$	1,069
Real estate - construction residential		2,100		2,271		307
Real estate - construction commercial		103		104		36
Real estate - residential		5,367		5,536		1,808
Real estate - commercial		4,097		4,662		1,482
Consumer		316		351		51

Total	$	14,720	$	15,724	$	4,753
Total impaired loans	$	36,038	$	39,269	$	4,753

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(in thousands)	Recorded Investment	Unpaid Principal Balance	Specific Reserves
December 31, 2013			
With no related allowance recorded:			
Commercial, financial and agricultural	$ 2,467	$ 2,593	$ 0
Real estate - construction residential	44	80	0
Real estate - construction commercial	6,101	7,148	0
Real estate - residential	2,121	2,654	0
Real estate - commercial	7,817	8,056	0
Consumer	259	282	0
Total	$ 18,809	$ 20,813	$ 0
With an allowance recorded:			
Commercial, financial and agricultural	$ 1,548	$ 1,607	$ 721
Real estate - construction residential	2,160	2,331	392
Real estate - construction commercial	514	514	304
Real estate - residential	4,396	4,570	1,374
Real estate - commercial	7,605	7,925	1,989
Consumer	43	45	16
Total	$ 16,266	$ 16,992	$ 4,796
Total impaired loans	$ 35,075	$ 37,805	$ 4,796

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

	Three Months Ended March 31,			
	2014		2013	
(in thousands)	Average Recorded Investment	Interest Recognized For the Period Ended	Average Recorded Investment	Interest Recognized For the Period Ended
With no related allowance recorded:				
Commercial, financial and agricultural	$ 2,496	$ 21	$ 2,937	$ 25
Real estate - construction residential	117	0	369	0
Real estate - construction commercial	6,998	0	2,616	0
Real estate - residential	2,901	6	2,736	0
Real estate - commercial	11,809	66	5,480	29
Consumer	25	0	189	0
Total	$ 24,346	$ 93	$ 14,327	$ 54
With an allowance recorded:				

Commercial, financial and agricultural	$	2,341	$	8	$	990	$	7
Real estate - construction residential		2,271		0		2,273		0
Real estate - construction commercial		105		0		6,475		1
Real estate - residential		5,479		40		4,082		20
Real estate - commercial		4,594		0		13,634		26
Consumer		343		0		45		0
Total	$	15,133	$	48	$	27,499	$	54
Total impaired loans	$	39,479	$	141	$	41,826	$	108

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 $141,000 and $108,000, for the three months ended March 31, 2014 and 2013, respectively. The average recorded investment in impaired loans is calculated on a monthly basis during the periods reported. Contractual interest lost on loans in non-accrual status was $289,000 and $350,000 for the three months ended March 31, 2014 and 2013, respectively.

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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 following table provides aging information for the Company s past due and non-accrual loans at March 31, 2014 and December 31, 2013.

(in thousands)	Current or Less Than 30 Days Past Due	30 - 89 Days Past Due	90 Days Past Due And Still Accruing	Non-Accrual	Total
March 31, 2014					
Commercial, Financial, and Agricultural	$ 129,201	$ 513	$ 0	$ 2,632	$ 132,346
Real Estate Construction - Residential	19,821	96	0	2,143	22,060
Real Estate Construction - Commercial	51,347	56	1	5,936	57,340
Real Estate Mortgage - Residential	222,827	3,350	194	3,939	230,310
Real Estate Mortgage - Commercial	372,245	2,047	0	9,838	384,130
Installment and Other Consumer	18,535	261	9	316	19,121
Total	$ 813,976	$ 6,323	$ 204	$ 24,804	$ 845,307
December 31, 2013					
Commercial, Financial, and Agricultural	$ 131,091	$ 942	$ 0	$ 1,684	$ 133,717
Real Estate Construction - Residential	18,738	66	0	2,204	21,008
Real Estate Construction - Commercial	48,230	595	0	6,251	55,076
Real Estate Mortgage - Residential	217,179	4,068	129	4,165	225,541
Real Estate Mortgage - Commercial	372,651	725	100	9,074	382,550
Installment and Other Consumer	21,048	291	14	302	21,655
Total	$ 808,937	$ 6,687	$ 243	$ 23,680	$ 839,547

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 (1) one or more weaknesses that could jeopardize timely liquidation exits; or (2) the margin or liquidity of an asset is sufficiently tenuous that adverse trends could result in a collection problem. Loans classified as *substandard* are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Loans so classified may have a well defined weakness or weaknesses that jeopardize the repayment of the debt. Such loans are characterized by the distinct possibility that the Company may sustain some loss if the deficiencies are not corrected. It is the Company s policy to discontinue the accrual of interest income on loans when management believes that the collection of interest or principal is doubtful. Loans are placed on *non-accrual* status when (1) deterioration in the financial condition of the borrower exists for which payment of full principal and interest is not expected, or (2) payment of principal or interest has been in default for a period of 90 days or more and the asset is not both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectability of such principal; otherwise, such receipts are recorded as interest income on a cash basis.

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The following table presents the risk categories by class at March 31, 2014 and December 31, 2013.

(in thousands)	Commercial, Financial, & Agricultural	Real Estate Construction - Residential	Real Estate Construction - Commercial	Real Estate Mortgage - Residential	Real Estate Mortgage - Commercial	Installment and other Consumer	Total
At March 31, 2014							
Watch	$ 16,988	$ 2,485	$ 5,928	$ 26,615	$ 24,169	$ 285	$ 76,470
Substandard	5,558	91	1,029	10,030	10,233	230	27,171
Non-accrual	2,632	2,143	5,936	3,939	9,838	316	24,804
Total	$ 25,178	$ 4,719	$ 12,893	$ 40,584	$ 44,240	$ 831	$ 128,445
At December 31, 2013							
Watch	$ 15,016	$ 2,007	$ 6,111	$ 26,331	$ 23,662	$ 388	$ 73,515
Substandard	7,553	92	1,403	8,579	14,510	281	32,418
Non-accrual	1,684	2,204	6,251	4,165	9,074	302	23,680
Total	$ 24,253	$ 4,303	$ 13,765	$ 39,075	$ 47,246	$ 971	$ 129,613

Troubled Debt Restructurings

At March 31, 2014, loans classified as troubled debt restructurings (TDRs) totaled $22.2 million, of which $11.0 million were on non-accrual status and $11.2 million were on accrual status. At December 31, 2013, TDRs totaled $21.5 million, of which $10.1 million were on non-accrual status and $11.4 million were on accrual status. 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 $2.4 million and $2.2 million related to TDRs were allocated to the allowance for loan losses at March 31, 2014 and December 31, 2013, respectively.

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

	Three Months Ended March 31,					
	2014			2013		
		Recorded Investment (1)			Recorded Investment (1)	
(in thousands)	Number of Contracts	Pre-Modification	Post-Modification	Number of Contracts	Pre-Modification	Post-Modification

Troubled Debt Restructurings						
Commercial, financial and agricultural	2	$ 244	$ 244	0	$ 0	$ 0
Real estate construction - commercial	0	0	0	0	0	0
Real estate mortgage - residential	1	1,256	1,185	1	619	619
Real estate mortgage - commercial	0	0	0	0	0	0
Consumer	0	0	0	0	0	0
Total	3	$ 1,500	$ 1,429	1	$ 619	$ 619

(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.

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The Company s portfolio of loans classified as TDRs include concessions such as interest rates below the current market rate, deferring principal payments, and extending maturity dates. Once a loan becomes a TDR, it will continue to be reported as a TDR until it is ultimately repaid in full, charged-off, or the collateral for the loan is foreclosed and sold. The Company considers a loan in TDR status in default when the borrower s payment according to the modified terms is at least 90 days past due or has defaulted due to expiration of the loan s maturity date. During the three months ended March 31, 2014, three loans meeting the TDR criteria were modified compared to one loan during the three months ended March 31, 2013. There were no loans modified as a TDR that defaulted during the three months ended March 31, 2014 and 2013, respectively, and within twelve months of their modification date.

(3) Real Estate and Other Assets Acquired in Settlement of Loans

(in thousands)		**March 31, 2014**		**December 31, 2013**
Real estate construction - residential	$	32	$	114
Real estate construction - commercial		10,020		10,020
Real estate mortgage - residential		332		830
Real estate mortgage - commercial		8,289		8,537
Repossessed assets		23		41
Total	$	18,696	$	19,542
Less valuation allowance for other real estate owned		(4,642)		(4,675)
Total other real estate owned and foreclosed assets	$	14,054	$	14,867

Changes in the net carrying amount of other real estate owned and repossessed assets for the three months ended March 31, 2014 and 2013, respectively, were as follows:

		Three Months Ended March 31, 2014		**2013**
Balance at beginning of period	$	19,542	$	29,729
Additions		259		2,470
Proceeds from sales		(1,094)		(604)
Charge-offs against the valuation allowance for other real estate owned		(156)		(136)
Net gain on sales		145		13
Total other real estate owned and repossessed assets	$	18,696	$	31,472
Less valuation allowance for other real estate owned		(4,642)		(8,344)
Balance at end of period	$	14,054	$	23,128

During the three months ended March 31, 2014 and 2013, net charge-offs against the allowance for loan losses at the time of foreclosure were approximately $162,000 and $374,000, respectively.

Activity in the valuation allowance for other real estate owned in settlement of loans for the three months ended March 31, 2014 and 2013, respectively, is summarized as follows:

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(in thousands)	Three Months Ended March 31, 2014		2013	
Balance, beginning of period	$	4,675	$	6,137
Provision for other real estate owned		123		2,343
Charge-offs		(156)		(136)
Balance, end of period	$	4,642	$	8,344

(4) Investment Securities

The amortized cost and fair value of debt securities classified as available-for-sale at March 31, 2014 and December 31, 2013 were as follows:

(in thousands)		Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair value
March 31, 2014								
U.S. Treasury	$	1,000	$	1	$	0	$	1,001
Government sponsored enterprises		71,052		325		566		70,811
Asset-backed securities		111,096		813		2,534		109,375
Obligations of states and political subdivisions		31,597		574		131		32,040
Total available-for-sale securities	$	214,745	$	1,713	$	3,231	$	213,227
December 31, 2013								
U.S. Treasury	$	1,000	$	3	$	0	$	1,003
Government sponsored enterprises		61,006		377		767		60,616
Asset-backed securities		112,747		817		3,191		110,373
Obligations of states and political subdivisions		33,637		568		212		33,993
Total available-for-sale securities	$	208,390	$	1,765	$	4,170	$	205,985

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

Investment securities that are classified as restricted equity securities primarily consist of Federal Home Loan Bank stock and the Company s interest in statutory trusts. These securities are reported at cost in the amount of $4.0 million as of both March 31, 2014 and December 31, 2013, respectively.

Debt securities with carrying values aggregating approximately $186.2 million and $145.8 million at March 31, 2014 and December 31, 2013, 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, 2014, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without prepayment penalties.

(in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 7,566	$ 7,629
Due after one year through five years	55,166	55,592
Due after five years through ten years	39,901	39,653
Due after ten years	1,016	978
Total	103,649	103,852
Asset-backed securities	111,096	109,375
Total available-for-sale securities	$ 214,745	$ 213,227

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, 2014 and December 31, 2013 were as follows:

	Less than 12 months		12 months or more		Total	Total
(in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
At March 31, 2014						
Government sponsored enterprises	$ 42,190	$ (566)	$ 0	$ 0	$ 42,190	$ (566)
Asset-backed securities	68,052	(2,013)	11,736	(521)	79,788	(2,534)
Obligations of states and political subdivisions	7,731	(90)	634	(41)	8,365	(131)
Total	$ 117,973	$ (2,669)	$ 12,370	$ (562)	$ 130,343	$ (3,231)
(in thousands)						
At December 31, 2013						
Government sponsored enterprises	$ 25,771	$ (767)	$ 0	$ 0	$ 25,771	$ (767)
Asset-backed securities	76,048	(2,940)	5,941	(251)	81,989	(3,191)
Obligations of states and political subdivisions	6,907	(159)	450	(53)	7,357	(212)
Total	$ 108,726	$ (3,866)	$ 6,391	$ (304)	$ 115,117	$ (4,170)

The total available for sale portfolio consisted of approximately 294 securities at March 31, 2014. The portfolio included 97 securities having an aggregate fair value of $130.3 million that were in a loss position at March 31, 2014. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled $12.4 million at fair value. The $3.2 million aggregate unrealized loss included in accumulated other comprehensive income at March 31, 2014 was caused by interest rate fluctuations.

The total available for sale portfolio consisted of approximately 348 securities at December 31, 2013. The portfolio included 96 securities having an aggregate fair value of $115.1 million that were in a loss position at December 31, 2013. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled $6.4 million at fair value.

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The $4.2 million aggregate unrealized loss included in accumulated other comprehensive income at December 31, 2013 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, 2014 and December 31, 2013, respectively.

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 it will be required to sell such investment securities.

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

	Three Months Ended March 31,			
(in thousands)	**2014**		**2013**	
Gains realized on sales	$	0	$	294
Losses realized on sales		0		0
Other-than-temporary impairment recognized		0		0
Investment securities gains	**$**	0	**$**	294

(5) Intangible Assets

Core Deposit Intangible Asset

Core deposit intangible assets in the amount of $4.8 million were fully amortized as of December 31, 2013. Changes in the net carrying amount of core deposit intangible assets for the three months March 31, 2013 is as follows:

Three Months Ended

(in thousands)		March 31, 2013
Balance at beginning of period	$	135
Additions		0
Amortization		(101)
Balance at end of period	$	34

Mortgage Servicing Rights

At March 31, 2014 and December 31, 2013, the Company serviced mortgage loans for others totaling $319.3 million and $322.5 million, respectively. Mortgage loan servicing fees, reported as non-interest income, earned on loans sold were $223,000 and $217,000 for the three months ended March 31, 2014 and 2013, respectively.

The table below presents changes in mortgage servicing rights (MSRs) for the three months ended March 31, 2014 and 2013.

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(in thousands)	Three Months Ended March 31, 2014	2013
Balance at beginning of period	$ 3,036	$ 2,549
Originated mortgage servicing rights	50	197
Changes in fair value:		
Due to change in model inputs and assumptions (1)	106	153
Other changes in fair value (2)	(152)	(210)
Balance at end of period	$ 3,040	$ 2,689

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

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

The following key data and assumptions were used in estimating the fair value of the Company s MSRs as of the three months ended March 31, 2014 and 2013:

	Three Months Ended March 31, 2014	2013
Weighted average constant prepayment rate	9.07%	17.63%
Weighted average note rate	4.01%	4.12%
Weighted average discount rate	9.08%	8.03%
Weighted average expected life (in years)	6.20	4.10

(6) Income Taxes

Income taxes as a percentage of earnings (loss) before income taxes as reported in the consolidated financial statements were 34.5% for the three months ended March 31, 2014 compared to 31.3% for the three months ended March 31, 2013.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income 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 strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not the Company will realize the benefits of these temporary differences at March 31, 2014 and, therefore, did not establish a valuation reserve.

(7) Stockholders Equity

Accumulated Other Comprehensive Income (Loss)

The following details the change in the components of the Company s accumulated other comprehensive income (loss) for the three months ended March 31, 2014 and 2013:

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(in thousands)	Unrealized Loss on Securities (1)	Unrecognized Net Pension and Postretirement Costs (2)	Accumulated Other Comprehensive (Loss) Income
Balance, December 31, 2013	$ (1,491)	$ 722	$ (769)
Other comprehensive income, before reclassifications	886	0	886
Amounts reclassified from accumulated other comprehensive income	0	19	19
Current period other comprehensive income, before tax	886	19	905
Income tax expense	(337)	(7)	(344)
Current period other comprehensive income, net of tax	549	12	561
Balance, March 31, 2014	$ (942)	$ 734	$ (208)
Balance, December 31, 2012	$ 3,265	$ (1,440)	$ 1,825
Other comprehensive (loss) income, before reclassifications	(957)	0	(957)
Amounts reclassified from accumulated other comprehensive income	(294)	27	(267)
Current period other comprehensive (loss) income, before tax	(1,251)	27	(1,224)
Income tax benefit (expense)	529	(11)	518
Current period other comprehensive (loss) income, net of tax	(722)	16	(706)
Balance, March 31, 2013	$ 2,543	$ (1,424)	$ 1,119

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

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

(8) Employee Benefit Plans

Employee Benefits

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

(in thousands)	Threee Months Ended March 31, 2014	2013
Payroll taxes	$ 293	$ 304
Medical plans	518	491
401k match and profit sharing	153	75
Pension plan	236	286
Other	11	47
Total employee benefits	$ 1,211	$ 1,203

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

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Pension

The Company provides a noncontributory defined benefit pension plan for all full-time employees. An employer is required to recognize the funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. Under the Company s funding policy for the defined benefit pension plan, contributions are made to a trust as necessary to provide for current service and for any unfunded accrued actuarial liabilities over a reasonable period. To the extent that these requirements are fully covered by assets in the trust, a contribution might not be made in a particular year. The Company has not made any contributions to the defined benefit plan for the current plan year. The minimum required contribution for the 2014 plan year is estimated to be $1.3 million. The Company has not determined whether it will make any contributions other than the minimum required funding contribution for 2014.

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:

(in thousands)		**Estimated 2014**		**Actual 2013**
Service cost - benefits earned during the year	$	981	$	1,174
Interest costs on projected benefit obligations		732		646
Expected return on plan assets		(887)		(797)
Expected administrative expenses		40		40
Amortization of prior service cost		79		79
Amortization of unrecognized net loss		0		31
Net periodic pension expense	$	945	$	1,173
Pension expense - three months ended March 31 (actual)	$	236	$	286

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(9) Stock Compensation

The Company s stock option plan provides for the grant of options to purchase up to 547,492 shares of the Company s common stock to officers and other key employees of the Company and its subsidiaries. All options have been granted at exercise prices equal to fair value and vest over periods ranging from four to five years, except options issued in 2008 to acquire 11,578 shares that vested immediately.

The following table summarizes the Company s stock option activity:

	Number of Shares		Weighted average Exercise Price	Weighted Average Contractual Term (in years)		Aggregate Intrinsic Value ($000)
Outstanding, beginning of period	121,405	$	24.14			
Granted	0		0.00			
Exercised	0		0.00			
Forfeited	0		0.00			
Expired	(18,255)		28.97			
Outstanding, March 31, 2014	103,150	$	23.28	2.70	$	0.00
Exercisable, March 31, 2014	88,633	$	23.49	2.50	$	0.00

Options have been adjusted to reflect a 4% stock dividend paid on July 1, 2013.

Total stock-based compensation expense for the three months ended March 31, 2014 and 2013 was $6,000 and $2,000, respectively. As of March 31, 2014, the total unrecognized compensation expense related to non-vested stock awards was $44,000 and the related weighted average period over which it is expected to be recognized is approximately 1.6 years.

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(10) Earnings (Loss) per Share

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

	Three Months Ended March 31,			
(dollars in thousands, except per share data)	**2014**		**2013**	
Basic earnings (loss) per common share:				
Net income (loss)	$	1,987	$	(136)
Less:				
Preferred stock dividends and accretion of discount		0		295
Net income (loss) available to common shareholders	$	1,987	$	(431)
Basic earnings (loss) per share	$	0.39	$	(0.09)
Diluted earnings (loss) per common share:				
Net income (loss)	$	1,987	$	(136)
Less:				
Preferred stock dividends and accretion of discount		0		295
Net income (loss) available to common shareholders	$	1,987	$	(431)
Average shares outstanding		5,032,679		5,032,679
Effect of dilutive stock options		0		0
Average shares outstanding including dilutive stock options		5,032,679		5,032,679
Diluted earnings (loss) per share	$	0.39	$	(0.09)

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 common shareholders. In addition, proceeds from the assumed exercise of dilutive options along with the related tax benefit are assumed to be used to repurchase common shares at the average market price of such stock during the period.

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

	Three Months Ended March 31,	
	2014	**2013**
Anti-dilutive shares - option shares	103,150	188,491
Anti-dilutive shares - warrant shares		298,618
Total anti-dilutive shares	103,150	487,109

(11) Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain financial and nonfinancial assets and liabilities. The FASB ASC Topic 820, *Fair Value Measurements and Disclosures,* defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The standard applies whenever other standards require (permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, FASB clarified the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. As of March 31, 2014 and December 31, 2013, respectively, there were no transfers into or out of Levels 1-3.

The fair value hierarchy is as follows:

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

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.

ASC Topic 820 also provides guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased and on identifying circumstances when a transaction may not be considered orderly.

The Company is required to disclose assets and liabilities measured at fair value on a recurring basis separate from those measured at fair value on a nonrecurring basis. Nonfinancial assets measured at fair value on a nonrecurring basis would include foreclosed real estate, long-lived assets, and core deposit intangible assets, which are reviewed when circumstances or other events indicate that impairment may have occurred.

Valuation Methods for Instruments 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:

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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. Securities classified as available-for-sale are reported at fair value utilizing Level 2 inputs.

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		
(in thousands)	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
March 31, 2014				
Assets:				
U.S. Treasury	$ 1,001	$ 1,001	$ 0	$ 0
Government sponsored enterprises	70,811	0	70,811	0
Asset-backed securities	109,375	0	109,375	0
Obligations of states and political subdivisions	32,040	0	32,040	0
Mortgage servicing rights	3,040	0	0	3,040
Total	$ 216,267	$ 1,001	$ 212,226	$ 3,040

December 31, 2013				
Assets:				
U.S. Treasury	$ 1,003	$ 1,003	$ 0	$ 0
Government sponsored enterprises	60,616	0	60,616	0
Asset-backed securities	110,373	0	110,373	0
Obligations of states and political subdivisions	33,993	0	33,993	0
Mortgage servicing rights	3,036	0	0	3,036
Total	$ 209,021	$ 1,003	$ 204,982	$ 3,036

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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 Significant Unobservable Inputs (Level 3) Mortgage Servicing Rights Three Months Ended March 31,			
(in thousands)	**2014**		**2013**	
Balance at beginning of period	$	3,036	$	2,549
Total gains or losses (realized/unrealized):				
Included in earnings		(46)		(57)
Included in other comprehensive income		0		0
Purchases		0		0
Sales		0		0
Issues		50		197
Settlements		0		0
Balance at end of period	$	3,040	$	2,689

Total gains for the three months ended included in earnings attributable to the change in unrealized gains or losses related to assets still held were $106,000 and $153,000 at March 31, 2014 and 2013, respectively.

Quantitative Information about Level 3 Fair Value Measurements

			Input Value Three Months Ended March 31,	
	Valuation Technique	**Unobservable Inputs**	**2014**	**2013**
Mortgage servicing rights	Discounted cash flows	Weighted average constant prepayment rate	9.07%	17.63%
		Weighted average discount rate	9.08%	8.03%
		Weighted average expected life (in years)	6.20	4.10

Valuation methods for instruments 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:

Impaired Loans

The Company does not record loans at fair value on a recurring basis other than loans that are considered impaired. The net carrying value of impaired loans is generally based on fair values of the underlying collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. Once the fair value of the collateral has been determined and any impairment amount calculated, a specific reserve allocation is made. Because many of these inputs are not observable, the measurements are classified as Level 3. As of March 31, 2014, the Company identified $14.7 million in impaired loans that had specific allowances for losses aggregating $4.8 million. Related to these loans, there was $1.1 million in charge-offs recorded during the three months ended March 31, 2014. As of March 31, 2013, the Company identified $25.7 million in impaired loans that had specific allowances for losses aggregating $4.1 million. Related to these loans, there was $1.4 million in charge-offs recorded during the three months ended March 31, 2013.

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Other Real Estate Owned and Repossessed Assets

Other real estate owned and repossessed 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. Other real estate owned assets are recorded as held for sale initially at the lower of the loan balance or fair value of the collateral less estimated selling costs. The Company relies on external appraisals and assessment of property values by internal staff. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgment based on experience and expertise of internal specialists. Subsequent to foreclosure, 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			
(in thousands)	**Total Fair Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total Gains (Losses)***
March 31, 2014					
Assets:					
Impaired loans:					
Commercial, financial, & agricultural	$ 1,668	$ 0	$ 0	$ 1,668	$ (103)
Real estate construction - residential	1,793	0	0	1,793	(60)
Real estate construction - commercial	67	0	0	67	(414)
Real estate mortgage - residential	3,559	0	0	3,559	(94)
Real estate mortgage - commercial	2,615	0	0	2,615	(365)
Consumer	265	0	0	265	(18)
Total	$ 9,967	$ 0	$ 0	$ 9,967	$ (1,054)
Other real estate owned and repossessed assets	$ 14,054	$ 0	$ 0	$ 14,054	$ (30)
March 31, 2013					
Assets:					
Impaired loans:					
Commercial, financial, & agricultural	$ 737	$ 0	$ 0	$ 737	$ (10)
	1,959	0	0	1,959	(119)

Real estate construction - residential										
Real estate construction - commercial		5,762		0		0		5,762		0
Real estate mortgage - residential		2,774		0		0		2,774		(235)
Real estate mortgage - commercial		10,368		0		0		10,368		(987)
Consumer		38		0		0		38		0
Total	$	21,638	$	0	$	0	$	21,638	$	(1,351)
Other real estate owned and repossessed assets	$	23,128	$	0	$	0	$	23,128	$	(200)

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

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(12) 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

The fair values of loans are estimated by discounting the expected future cash flows using the current rates at which similar loans could be made to borrowers with similar credit ratings and for the same remaining maturities. The net carrying amount of impaired loans is generally based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC Topic 820.

Investment Securities

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

Federal Home Loan Bank (FHLB) Stock

Ownership of equity securities of FHLB is restricted and there is no established market for their resale. The carrying amount is a reasonable estimate of fair value.

Federal Funds Sold, Cash, and Due from Banks

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

Mortgage Servicing Rights

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

Cash Surrender Value - Life Insurance

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

Accrued Interest Receivable and Payable

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

Deposits

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

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Securities Sold under Agreements to Repurchase and Interest-bearing Demand Notes to U.S. Treasury

For securities sold under agreements to repurchase and interest-bearing demand notes to U.S. Treasury, the carrying amount is a reasonable estimate of fair value, as such instruments reprice in a short time period.

Subordinated Notes and Other Borrowings

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

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A summary of the carrying amounts and fair values of the Company s financial instruments at March 31, 2014 and December 31, 2013 is as follows:

(in thousands)	March 31, 2014 Carrying Amount	Fair Value	March 31, 2014 Fair Value Measurements: Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Net Significant Unobservable Inputs (Level 3)
Assets:					
Cash and due from banks	$ 24,314	$ 24,314	$ 24,314	$ 0	$ 0
Federal funds sold and overnight interest-bearing deposits	16,920	16,920	16,920	0	0
Investment in available-for-sale securities	213,227	213,227	1,001	212,226	0
Loans, net	832,462	835,199	0	0	835,199
Investment in FHLB stock	2,315	2,315	0	2,315	0
Mortgage servicing rights	3,040	3,040	0	0	3,040
Cash surrender value - life insurance	2,233	2,233		2,233	0
Accrued interest receivable	4,441	4,441	4,441	0	0
	$ 1,098,952	$ 1,101,689	$ 46,676	$ 216,774	$ 838,239
Liabilities:					
Deposits:					
Non-interest bearing demand	$ 189,925	$ 189,925	$ 189,925	$ 0	$ 0
Savings, interest checking and money market	453,724	453,724	453,724	0	0
Time deposits	344,087	346,442	0	0	346,442
Federal funds purchased and securities sold under agreements to repurchase	20,761	20,761	20,761	0	0
Subordinated notes	49,486	34,081	0	34,081	0
Federal Home Loan Bank advances	24,000	25,261	0	25,261	0
Accrued interest payable	412	412	412	0	0
	$ 1,082,395	$ 1,070,606	$ 664,822	$ 59,342	$ 346,442

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(in thousands)	December 31, 2013 Carrying Amount	December 31, 2013 Fair Value	December 31, 2013 Fair Value Measurements: Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Net Significant Unobservable Inputs (Level 3)
Assets:					
Cash and due from banks	$ 27,079	$ 27,079	$ 27,079	$ 0	$ 0
Federal funds sold and overnight interest-bearing deposits	1,360	1,360	1,360	0	0
Investment in available-for-sale securities	205,985	205,985	1,003	204,982	0
Loans, net	825,828	829,223	0	0	829,223
Investment in FHLB stock	2,354	2,354	0	2,354	0
Mortgage servicing rights	3,036	3,036	0	0	3,036
Cash surrender value - life insurance	2,213	2,213		2,213	0
Accrued interest receivable	4,999	4,999	4,999	0	0
	$ 1,072,854	$ 1,076,249	$ 34,441	$ 209,549	$ 832,259
Liabilities:					
Deposits:					
Non-interest bearing demand	$ 187,382	$ 187,382	$ 187,382	$ 0	$ 0
Savings, interest checking and money market	419,085	419,085	419,085	0	0
Time deposits	350,004	352,432	0	0	352,432
Federal funds purchased and securities sold under agreements to repurchase	31,084	31,084	31,084	0	0
Subordinated notes	49,486	32,048	0	32,048	0
Federal Home Loan Bank advances	24,000	25,366	0	25,366	0
Accrued interest payable	426	426	426	0	0
	$ 1,061,467	$ 1,047,823	$ 637,977	$ 57,414	$ 352,432

Off-Balance Sheet Financial Instruments

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

Limitations

The fair value estimates provided are made at a point in time based on market information and information about the financial instruments. Because no market exists for a portion of the Company s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the fair value estimates.

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(13) Repurchase Reserve Liability

The Company s repurchase reserve liability for estimated losses incurred on sold loans that are included in gain on sales of mortgage loans was $160,000 at March 31, 2014. This liability represents management s estimate of the potential repurchase or make-whole liability for residential mortgage loans originated for sale that may arise from representation and warranty claims that could relate to a variety of issues, including but not limited to, misrepresentation of facts, appraisal issues, or program requirements that may not meet investor guidelines. Although the Company has not experienced any historical repurchase losses, it was notified during the third quarter of 2013 by one of its two investors, Freddie Mac, that fifteen loans which were foreclosed upon from 2007 to the present, are being reviewed for quality control purposes and may result in loss indemnification payments to the investor as reimbursement for losses. The balance of these loans at foreclosure date totaled $1.5 million. During the fourth quarter of 2013 and through March 31, 2014, the Company settled these loan foreclosures resulting in payments totaling $119,000 for reimbursement of costs incurred by Freddie Mac on three of these foreclosures. The remaining twelve foreclosures were settled without incurring any additional costs. At March 31, 2014, the Company was servicing 3,158 loans sold to the secondary market with a balance of approximately $319.3 million compared to 3,114 loans sold with a balance of approximately $322.5 million at December 31, 2013.

(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, 2014, no amounts have been accrued for any estimated losses for these financial instruments.

The contractual amount of off-balance-sheet financial instruments as of the periods indicated:

(in thousands)	**March 31, 2014**	**December 31, 2013**

Commitments to extend credit	$ 121,100	$ 117,880
Commitments to originate residential first and second mortgage loans	1,866	1,852
Standby letters of credit	1,591	1,826

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 on e month to five years at March 31, 2014.

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Pending Litigation

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

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

And Results of Operations

Forward-Looking Statements

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

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

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

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

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, or the Dodd-Frank Act, was enacted on July 21, 2010. Provisions of the Act address many issues including, but not limited to, capital, interchange fees, compliance and risk management, debit card overdraft fees, the establishment of a new consumer regulator, healthcare, incentive compensation, expanded disclosures and corporate governance. While many of the new regulations under the Act are expected to primarily impact financial institutions with assets greater than $10 billion, the Company expects these new regulations could reduce revenues and increase expenses in the future. Management is currently assessing the impact of the Act and of the regulations anticipated to be promulgated under the Act.

We have described under the caption *Risk Factors* in the Company s Annual Report on Form 10-K for the year ended December 31, 2013, 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

Through the branch network of its subsidiary bank, the Company, with $1.2 billion in assets at March 31, 2014, provides a broad range of commercial and personal banking services, including certificates of deposit, individual retirement and other time deposit accounts, checking and other demand deposit accounts, interest checking accounts, savings accounts, and money market accounts. The Company also provides a wide range of lending services, including real estate, commercial, installment, and other consumer loans. Other financial services that the Company provides include automated teller machines, trust services, credit-related insurance, and safe-deposit boxes. The geographic areas in which the Company provides products and services include the communities in and surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson, and Lee s Summit, Missouri.

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

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

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, Hawthorn Bank (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 by the Board of Governors of the Federal Reserve System.

CRITICAL ACCOUNTING POLICIES

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

Allowance for Loan Losses

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

Income Taxes

Income taxes are accounted for under the asset/liability method by recognizing the amount of taxes payable or refundable for the current period and deferred tax assets and liabilities for future tax consequences of events that have been recognized in the Company s financial statements or tax returns. Judgment is required in addressing the Company s future tax consequences of events that have been recognized in the consolidated financial statements or tax returns such as realization of the effects of temporary differences, net operating loss carry forwards and changes in tax laws or interpretations thereof. A valuation allowance is established when in the judgment of management, it is more likely than not that such deferred tax assets will not become realizable. In this case, the Company would adjust the recorded value of the deferred tax asset, which would result in a direct charge to income tax expense and earnings in the period that the determination was made. Likewise, the Company would reverse the valuation allowance when it is expected to realize the deferred tax asset. Critical to the assessment is the Company s estimates and judgments related to future taxable income which is based on historical financial performance and assumptions related to the forecasts of future performance. In addition, the Company is subject to the continuous examination of its tax returns by the Internal Revenue Service and other taxing authorities. The Company accrues for penalties and interest related to income taxes in income tax expense. As of March 31, 2014, the Company has not recognized any tax liabilities or any interest or penalties in income tax expense related to uncertain tax positions.

Other Real Estate Owned and Repossessed Assets

Other real estate owned and repossessed assets consist 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. Other real estate owned assets are initially recorded as held for sale at the fair value of the collateral less estimated selling costs. Any adjustment is recorded as a charge-off against the allowance for loan losses. The Company relies on external appraisals and assessment of property values by internal staff. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgment based on experience and expertise of internal specialists. Subsequent to foreclosure, valuations are updated periodically, and the assets may be written down to reflect a new cost basis. The write-downs are recorded as other real estate expense, net. The Company establishes a valuation allowance related to other real estate owned on an asset-by-asset basis. The valuation allowance is created during the holding period when the fair value less cost to sell is lower than the cost of the property.

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, 2014 and 2013, 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

(In thousands, except per share data)	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Per Share Data		
Basic earnings (loss) per common share	$ 0.39	$ (0.09)
Diluted earnings (loss) per common share	0.39	(0.09)
Dividends paid on preferred stock		228
Accretion of discount on preferred stock		72
Dividends paid on common stock	252	242
Book value per common share	15.24	14.48
Market price per common share	13.23	11.08
Selected Ratios		
(Based on average balance sheets)		
Return on total assets	0.70%	(0.05)%
Return on common stockholders equity	10.67%	(2.33)%
Common stockholders equity to total assets	6.57%	7.85%
Efficiency ratio (1)	74.17%	93.70%
Efficiency ratio (2)	73.10%	73.20%
(Based on end-of-period data)		
Common stockholders equity to assets	6.58%	7.66%
Stockholders equity to assets	6.58%	6.14%
Total risk-based capital ratio	15.51%	16.84%
Tier 1 risk-based capital ratio	11.67%	13.55%
Leverage ratio (3)	8.87%	10.09%

(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) Does not include other real estate expense or gain on sale of investment securities.

(3) Leverage ratio is calculated by dividing Tier 1 capital ratio by average total consolidated assets.

RESULTS OF OPERATIONS ANALYSIS

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

	Three Months Ended March 31,			
(In thousands)	**2014**	**2013**	**$ Change**	**% Change**
Net interest income	$ 9,654	$ 9,729	$ (75)	(0.8)%
Provision for loan losses		1,000	(1,000)	(100.0)
Noninterest income	2,085	3,007	(922)	(30.7)
Noninterest expense	8,707	11,934	(3,227)	(27.0)
Income (loss) before income taxes	3,032	(198)	3,230	1,631.3
Income tax expense (benefit)	1,045	(62)	1,107	1,785.5
Net income (loss)	$ 1,987	$ (136)	$ 2,123	1,561.0%
Preferred stock dividends and accretion of discount		295	(295)	(100.0)
Net income (loss) available to common shareholders	$ 1,987	$ (431)	$ 2,418	561.0%

Business Events On December 19, 2008, the Company announced its participation in the U.S. Treasury Department s Capital Purchase Program (CPP), a voluntary program that provides capital to financially healthy banks. Participation in this program included the Company s issuance of 30,255 shares of senior preferred stock (with a par value of $1,000 per share) and a ten year warrant to purchase approximately 287,133 shares of common stock. On May 9, 2012, the Company redeemed 12,000 of the 30,255 shares of preferred stock issued under the U.S. Treasury s CPP program, and on May 15, 2013, the remaining 18,255 shares were redeemed.

On June 11, 2013, the common stock warrant issued under the U.S. Treasury Department s CPP program was repurchased by the Company pursuant to a letter agreement between the Treasury and the Company for a total repurchase price of $540,000, or $1.88 per warrant share. The repurchase price was based on the fair value of the warrant as agreed upon by the Company and the Treasury. The repurchase of the warrant ends the Company s participation in the U.S. Treasury Department s CPP.

For the fifth consecutive year, on July 1, 2013, the Company distributed a four percent stock dividend to shareholders of record at the close of business on June 15, 2013. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect the stock dividend.

Consolidated net income of $2.0 million for the three months ended March 31, 2014 increased $2.1million compared to a consolidated net loss of $136,000 for the three months ended March 31, 2013. Net income available to common shareholders for the three months ended March 31, 2014 was $2.0 million, or $0.39 per diluted common share, compared to a net loss available to common shareholders of $431,000, or $(0.09) per diluted common share for the three months ended March 31, 2013. For the quarter ended March 31, 2014, the return on average assets was 0.70%, the return on average common stockholders equity was 10.67%, and the efficiency ratio was 74.17%.

Net interest income was $9.7 million for both the three months ended March 31, 2014 and 2013. The net interest margin increased to 3.72% for the three months ended March 31, 2014, compared to 3.65% for the three months ended March 31, 2013 primarily resulting from a decrease in the Company s cost of certificate of deposits. During the third quarter of 2013, $23.0 million from a 58 month 6.05% certificate of deposit special matured and approximately $5.7 million was reinvested at current market rates.

The lower ***provision for loan losses*** for the three months ended March 31, 2014 compared to the three months ended March 31, 2013 was primarily a result of the improving credit quality in the Company s historical loss analysis and reduced levels of nonperforming loans. Net charge-offs for the three months ended March 31, 2014, were $874,000, or 0.10% of average loans compared to $3.2 million, or 0.15% of average loans for the three months ended March 31, 2013. Non-performing loans totaled $36.2 million, or 4.29% of total loans, at March 31, 2014 compared to $35.3 million, or 4.21% of total loans, at December 31, 2013, and $38.6 million, or 4.63%of total loan, at March 31, 2013.

Non-interest income decreased $922,000, or 30.7%, for the three months ended March 31, 2014 compared to the three months ended March 31, 2013. These changes are discussed in greater detail below under Non-interest Income.

Non-interest expense decreased $3.2 million, or 27.0%, for the three months ended March 31, 2014 compared to the three months ended March 31, 2013. These changes are discussed in greater detail below under Non-interest Expense.

Average Balance Sheets

Net interest income is the largest source of revenue resulting from the Company s lending, investing, borrowing, and deposit gathering activities. It is affected by both changes in the level of interest rates and changes in the amounts and mix of interest earning assets and interest bearing liabilities. The following table presents average balance sheets, net interest income, average yields of earning assets, average costs of interest bearing liabilities, net interest spread and net interest margin on a fully taxable equivalent basis for each of the periods ended March 31, 2014 and 2013, respectively.

	Three Months Ended March 31,					
	2014			2013		
(In thousands)	Average Balance	Interest Income/ Expense(1)	Rate Earned/ Paid(1)	Average Balance	Interest Income/ Expense(1)	Rate Earned/ Paid(1)
ASSETS						
Loans: (2) (4)						
Commercial	$ 129,845	$ 1,502	4.69%	$ 126,969	$ 1,559	4.98%
Real estate construction - residential	22,962	238	4.20	22,746	252	4.49
Real estate construction - commercial	56,768	606	4.33	44,681	514	4.67
Real estate mortgage - residential	228,530	2,753	4.89	219,843	2,781	5.13
Real estate mortgage - commercial	383,157	4,468	4.73	400,681	4,928	4.99
Consumer	20,364	332	6.61	25,069	378	6.12
Total loans	$ 841,626	$ 9,899	4.77%	$ 839,989	$ 10,412	5.03%
Investment securities: (3)						
U.S. Treasury	$ 1,003	$ 3	1.21%	$ 2,029	$ 8	1.60%
Government sponsored enterprises	66,822	217	1.32	71,949	216	1.22
Asset backed securities	108,941	649	2.42	117,396	670	2.31
State and municipal	33,221	295	3.60	35,157		