

HAWTHORN BANCSHARES, INC.

Form 10-Q

November 09, 2007

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

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2007**

or

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

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

Missouri
(State or other jurisdiction of
of incorporation or organization)

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

**300 Southwest Longview Boulevard, Lees Summit,
Missouri**
(Address of principal executive offices)

64081
(Zip Code)

(816) 347-8100
(Registrant's telephone number, including area code)

N/A

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of November 9, 2007 the registrant had 4,174,495 shares of common stock, par value \$1.00 per share, outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)

| | September 30, 2007 | December 31, 2006 |
|--|-------------------------------|------------------------------|
| ASSETS | | |
| Loans: | \$ 882,889,587 | \$ 812,312,759 |
| Less allowance for loan losses | 9,217,966 | 9,015,378 |
| Loans, net | 873,671,621 | 803,297,381 |
| Investments in available for sale debt securities, at fair value | 174,344,734 | 183,566,135 |
| Investments in equity securities, at cost | 6,293,350 | 6,207,175 |
| Federal funds sold and securities purchased under agreements to resell | 296,118 | 9,922,961 |
| Cash and due from banks | 27,359,983 | 43,077,605 |
| Premises and equipment | 40,247,769 | 34,706,857 |
| Other real estate owned and repossessed assets | 4,730,314 | 2,734,500 |
| Accrued interest receivable | 9,327,978 | 8,773,686 |
| Mortgage servicing rights | 1,230,062 | 1,350,375 |
| Goodwill | 40,323,775 | 40,323,775 |
| Intangible assets | 3,054,389 | 3,753,877 |
| Cash surrender value - life insurance | 1,802,435 | 1,750,420 |
| Other assets | 2,932,079 | 3,247,150 |
| Total assets | \$ 1,185,614,607 | \$ 1,142,711,897 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Demand deposits | \$ 126,728,941 | \$ 138,885,883 |
| Time deposits | 799,231,085 | 760,978,851 |
| Total deposits | 925,960,026 | 899,864,734 |
| Federal funds purchased and securities sold under agreements to repurchase | 25,996,935 | 29,460,492 |
| Interest-bearing demand notes to U.S. Treasury | | 1,735,638 |
| Subordinated notes | 49,486,000 | 49,486,000 |
| Other borrowed money | 62,152,260 | 47,368,315 |
| Accrued interest payable | 5,384,915 | 4,366,250 |
| Other liabilities | 6,502,239 | 5,485,878 |
| Total liabilities | 1,075,482,375 | 1,037,767,307 |
| Stockholders' equity: | | |

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| | | |
|---|------------------|------------------|
| Common stock \$1 par value; 15,000,000 shares authorized; 4,298,353 issued | 4,298,353 | 4,298,353 |
| Surplus | 22,460,001 | 22,248,319 |
| Retained earnings | 85,610,413 | 81,431,713 |
| Accumulated other comprehensive income (loss), net of tax | 332,538 | (381,286) |
| Treasury stock, 123,858 and 128,506 shares at cost | (2,569,073) | (2,652,509) |
| Total stockholders equity | 110,132,232 | 104,944,590 |
| Total liabilities and stockholders equity | \$ 1,185,614,607 | \$ 1,142,711,897 |

See accompanying notes to unaudited condensed consolidated financial statements.

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HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------------|--------------------------|-------------------|
| | September 30, | | September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Interest income: | | | | |
| Interest and fees on loans | \$ 16,893,715 | \$ 16,064,823 | \$ 48,411,899 | \$ 46,545,816 |
| Interest on debt securities: | | | | |
| Taxable | 1,449,274 | 1,444,437 | 4,416,454 | 4,220,388 |
| Nontaxable | 498,369 | 481,074 | 1,498,268 | 1,442,210 |
| Interest on federal funds sold and securities purchased under agreements to resell | 78,153 | 221,387 | 536,009 | 528,547 |
| Interest on interest-bearing deposits | 8,000 | 19,492 | 54,220 | 76,492 |
| Dividends and interest on equity securities | 64,656 | 83,252 | 243,172 | 223,699 |
| Total interest income | 18,992,167 | 18,314,465 | 55,160,022 | 53,037,152 |
| | | | | |
| Interest Expense: | | | | |
| NOW accounts | 417,360 | 322,507 | 1,078,231 | 1,104,083 |
| Savings accounts | 63,643 | 73,324 | 199,802 | 226,983 |
| Money market accounts | 1,525,207 | 1,377,511 | 4,203,301 | 3,769,533 |
| Certificates of deposit: | | | | |
| \$100,000 and over | 1,658,271 | 1,420,547 | 5,084,831 | 3,685,900 |
| Other time deposits | 3,903,084 | 3,262,639 | 11,162,624 | 8,969,634 |
| Federal funds purchased and securities sold under agreements to repurchase | 427,592 | 461,640 | 1,130,597 | 1,458,591 |
| Subordinated notes | 907,703 | 912,438 | 2,698,436 | 2,628,177 |
| Advances from Federal Home Loan Bank | 764,064 | 750,026 | 2,045,508 | 2,153,965 |
| Other borrowed money | 2 | 8,830 | 10,734 | 22,188 |
| Total interest expense | 9,666,926 | 8,589,462 | 27,614,064 | 24,019,054 |
| | | | | |
| Net interest income | 9,325,241 | 9,725,003 | 27,545,958 | 29,018,098 |
| | | | | |
| Provision for loan losses | 225,000 | 300,000 | 604,216 | 928,000 |
| | | | | |
| Net interest income after provision for loan losses | 9,100,241 | 9,425,003 | 26,941,742 | 28,090,098 |
| Continued on next page | | | | |

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HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME
 (Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|---------------------|--------------------------|---------------------|
| | September 30, | | September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Noninterest income: | | | | |
| Service charges on deposit accounts | \$ 1,306,969 | \$ 1,461,703 | \$ 3,892,536 | \$ 4,339,408 |
| Trust department income | 200,672 | 214,472 | 629,223 | 622,551 |
| Mortgage loan servicing fees, net | 60,059 | 102,370 | 249,851 | 326,646 |
| Gain on sale of mortgage loans, net | 159,653 | 126,686 | 501,156 | 328,520 |
| Loss on sales and calls of debt securities | | | (1,747) | (18,351) |
| Other | 367,828 | 311,342 | 2,197,372 | 892,890 |
| Total noninterest income | 2,095,181 | 2,216,573 | 7,468,391 | 6,491,664 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 4,484,240 | 4,254,272 | 14,154,003 | 12,942,420 |
| Occupancy expense | 573,762 | 499,840 | 1,566,057 | 1,400,006 |
| Furniture and equipment expense | 638,286 | 591,482 | 1,797,018 | 1,653,967 |
| Advertising and promotion | 272,796 | 234,298 | 701,761 | 621,636 |
| Postage, printing and supplies | 363,566 | 277,290 | 922,852 | 861,209 |
| Legal, examination, and professional fees | 292,465 | 333,575 | 1,203,555 | 946,664 |
| Processing expense | 324,860 | 261,202 | 878,866 | 776,222 |
| Amortization of intangible assets | 222,849 | 249,369 | 699,488 | 783,214 |
| Other | 988,349 | 780,591 | 2,816,715 | 2,265,640 |
| Total noninterest expense | 8,161,173 | 7,481,919 | 24,740,315 | 22,250,978 |
| Income before income taxes | 3,034,249 | 4,159,657 | 9,669,818 | 12,330,784 |
| Income taxes | 897,262 | 1,301,172 | 2,863,136 | 3,850,507 |
| Net income | \$ 2,136,987 | \$ 2,858,485 | \$ 6,806,682 | \$ 8,480,277 |
| Basic earning per share | \$ 0.51 | \$ 0.69 | \$ 1.63 | \$ 2.03 |
| Diluted earnings per share | \$ 0.51 | \$ 0.68 | \$ 1.61 | \$ 2.02 |
| Weighed average shares of common stock outstanding | | | | |
| Basic | 4,174,179 | 4,169,847 | 4,171,359 | 4,169,847 |
| Diluted | 4,213,563 | 4,202,485 | 4,216,682 | 4,202,762 |
| Dividends per share: | | | | |

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| | | | | | | | | |
|----------|----|------|----|------|----|------|----|------|
| Declared | \$ | 0.21 | \$ | 0.21 | \$ | 0.63 | \$ | 0.63 |
| Paid | \$ | 0.21 | \$ | 0.21 | \$ | 0.63 | \$ | 0.63 |

See accompanying notes to unaudited condensed consolidated financial statements.

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HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Unaudited)

| | Nine Months Ended September | |
|---|------------------------------------|------------------|
| | 30, | |
| | 2007 | 2006 |
| Cash flow from operating activities: | | |
| Net income | \$ 6,806,682 | \$ 8,480,277 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 604,216 | 928,000 |
| Depreciation expense | 1,470,540 | 1,360,457 |
| Net (accretion) amortization of debt securities premiums and discounts | (29,476) | 34,945 |
| Amortization of intangible assets | 699,488 | 783,214 |
| Stock based compensation expense | 194,691 | 162,741 |
| Increase in accrued interest receivable | (554,292) | (615,708) |
| Increase in cash surrender value life insurance | (52,015) | (47,672) |
| Increase in other assets | (303,820) | (230,848) |
| Increase in accrued interest payable | 1,018,665 | 1,212,918 |
| Increase in other liabilities | 1,016,361 | 505,510 |
| Loss on sales and calls of debt securities | 1,747 | 18,351 |
| Origination of mortgage loans for sale | (24,057,146) | (15,247,120) |
| Proceeds from the sale of mortgage loans held for sale | 24,558,302 | 15,575,640 |
| Gain on sale of mortgage loans | (501,156) | (328,520) |
| (Gain) Loss on disposition of premises and equipment | (4,271) | 25,952 |
| Other, net | 413,128 | 194,697 |
| Net cash provided by operating activities | 11,281,644 | 12,812,834 |
| Cash flow from investing activities: | | |
| Net increase in loans | (74,226,029) | (8,136,202) |
| Purchase of available-for-sale debt securities | (44,645,014) | (117,945,571) |
| Proceeds from maturities of available-for-sale debt securities | 37,102,209 | 109,781,262 |
| Proceeds from calls of available-for-sale debt securities | 10,921,200 | 950,038 |
| Proceeds from sales of available-for-sale debt securities | 6,910,634 | 1,985,020 |
| Purchase of equity securities | (1,310,900) | (1,008,150) |
| Proceeds from sales of equity securities | 1,224,725 | 742,000 |
| Purchase of premises and equipment | (7,505,467) | (2,020,077) |
| Proceeds from sales of premises and equipment | 498,286 | 69,202 |
| Proceeds from sales of other real estate owned and repossessions | 1,251,760 | 570,624 |
| Net cash used in investing activities | (69,778,596) | (15,011,854) |

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HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)
 (Unaudited)

| | Nine Months Ended September | |
|--|------------------------------------|-------------------|
| | 30, | |
| | 2007 | 2006 |
| Cash flow from financing activities: | | |
| Net (decrease) increase in demand deposits | \$ (12,156,942) | \$ 3,228,761 |
| Net increase (decrease) in interest-bearing transaction accounts | 15,212,993 | (19,314,069) |
| Net increase in time deposits | 23,039,241 | 26,366,533 |
| Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase | (3,463,557) | 4,548,459 |
| Net (decrease) increase in interest-bearing demand notes to U.S. Treasury | (1,735,638) | 791,135 |
| Proceeds from Federal Home Loan Bank advances | 103,000,000 | 176,355,627 |
| Repayment of Federal Home Loan Bank advances | (88,216,055) | (177,924,605) |
| Cash dividends paid | (2,627,982) | (2,627,004) |
| Sale of treasury stock | 100,427 | |
| Net cash provided by financing activities | 33,152,487 | 11,424,837 |
| Net (decrease) increase in cash and cash equivalents | (25,344,465) | 9,225,817 |
| Cash and cash equivalents, beginning of period | 53,000,566 | 47,730,549 |
| Cash and cash equivalents, end of period | \$ 27,656,101 | \$ 56,956,366 |
| Supplemental disclosure of cash flow information - Cash paid during period for: | | |
| Interest | \$ 26,595,399 | \$ 22,806,136 |
| Income taxes | 2,552,000 | 4,135,000 |
| Supplemental schedule of noncash investing activities - Other real estate and repossessions acquired in settlement of loans | \$ 3,247,574 | \$ 489,498 |
| See accompanying notes to unaudited condensed consolidated financial statements. | | |

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

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include all adjustments that, in the opinion of management, are necessary in order to make those statements not misleading. Certain amounts in the 2006 condensed consolidated financial statements have been reclassified to conform to the 2007 condensed consolidated presentation. Such reclassifications have no effect on previously reported net income or stockholders' equity. Operating results for the period ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

These unaudited condensed consolidated interim financial statements should be read in conjunction with our Company's audited consolidated financial statements included in its 2006 Annual Report to Shareholders under the caption "Consolidated Financial Statements" and incorporated by reference into its Annual Report on Form 10-K for the year ended December 31, 2006 as Exhibit 13.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed and omitted. These financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly our Company's consolidated financial position as of September 30, 2007 and the consolidated statement of earnings for the three and nine month-periods ended September 30, 2007 and 2006 and cash flows for the nine months ended September 30, 2007 and 2006.

Table of Contents**Earnings per Share**

The following table reflects, for the three and nine month periods ended September 30, 2007 and 2006, the numerators (net income) and denominators (average shares outstanding) for the basic and diluted net income per share computations:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|--------------|--|--------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income, basic and diluted | \$ 2,136,987 | \$ 2,858,485 | \$ 6,806,682 | \$ 8,480,277 |
| Average shares outstanding | 4,174,179 | 4,169,847 | 4,171,359 | 4,169,847 |
| Effect of dilutive stock options | 39,384 | 32,638 | 45,323 | 32,915 |
| Average shares outstanding including dilutive stock options | 4,213,563 | 4,202,485 | 4,216,682 | 4,202,762 |
| Basic earning per share | \$ 0.51 | \$ 0.69 | \$ 1.63 | \$ 2.03 |
| Diluted earnings per share | \$ 0.51 | \$ 0.68 | \$ 1.61 | \$ 2.02 |

Stock options that have a strike price greater than the current market price are considered anti-dilutive. For the three months ended September 30, 2007 and 2006, 6,258 and 5,524 shares of stock, respectively, are excluded in the calculation because their effect would be anti-dilutive. For the nine months ended September 30, 2007 and 2006, 2,733 and 5,311 shares of stock, respectively, are excluded in the calculation because their effect would be anti-dilutive.

Stock-Based Compensation

Total stock-based compensation expense was \$88,000 (\$58,000 after tax) and \$195,000 (\$128,000 after tax) for the three and nine-month periods ended September 30, 2007, respectively.

Total stock-based compensation expense was \$60,000 (\$40,000 after tax) and \$163,000 (\$107,000 after tax) for the three and nine-month periods ended September 30, 2006, respectively.

As of September 30, 2007, the total unrecognized compensation expense related to non-vested stock awards was \$571,000 and the related weighted average period over which it is expected to be recognized is approximately 3.2 years.

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The following table summarizes our Company's stock option activity for the nine-month period ended September 30, 2007:

| | Options | Weighted Average Exercise Price | Aggregate Intrinsic Value (000) | Weighted Average Contractual Term (in years) |
|---------------------------------|----------------|--|--|---|
| Outstanding, January 1, 2007 | 202,738 | \$24.54 | | |
| Granted | 48,104 | 33.50 | | |
| Exercised | (4,648) | 20.13 | | |
| Expired | | | | |
| Forfeited | (3,226) | 30.53 | | |
| Outstanding, September 30, 2007 | 242,968 | 27.23 | \$1,143 | 6.7 |
| Exercisable, September 30, 2007 | 140,186 | 23.69 | 1,077 | 5.3 |

Options outstanding at September 30, 2007 had an intrinsic value of \$1,143,000. Options exercisable at September 30, 2007 had an intrinsic value of approximately \$1,077,000. On April 27, 2007, 48,104 stock options were granted.

The weighted average grant date fair values of stock options granted during 2007 and the weighted average significant assumptions used to determine those fair values, using the Black-Scholes option-pricing model, are as follows:

| | |
|---------------------------------------|---------|
| Options granted during 2007: | |
| Grant date fair value per option | \$ 7.13 |
| Significant assumptions: | |
| Risk-free interest rate at grant date | 4.49% |
| Expected annual dividend yield | 2.50% |
| Expected stock price volatility | 20.00% |
| Expected life to exercise (years) | 6.25 |

Table of Contents**Comprehensive Income**

Comprehensive income for the three and nine-month periods ended September 30, 2007 and 2006 is summarized as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|--------------|--|--------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income | \$ 2,136,987 | \$ 2,858,485 | \$ 6,806,682 | \$ 8,480,277 |
| Other comprehensive income: | | | | |
| Unrealized gain on securities: | | | | |
| Unrealized gain on debt and equity securities available-for-sale, net of tax | 1,120,767 | 1,339,440 | 678,396 | 246,978 |
| Adjustment for loss on sales and calls of debt and equity securities, net of tax | | | 1,136 | 11,928 |
| Defined benefit pension plans: | | | | |
| Amortization of prior service cost included in net periodic pension cost, net of tax | 11,430 | | 34,292 | |
| Total other comprehensive income | 1,132,197 | 1,339,440 | 713,824 | 258,906 |
| Comprehensive income | \$ 3,269,184 | \$ 4,197,925 | \$ 7,520,506 | \$ 8,739,183 |

Intangible Assets

The gross carrying amount and accumulated amortization of our Company's amortized intangible assets as of September 30, 2007 and December 31, 2006 is as follows:

| | September 30, 2007 | | December 31, 2006 | |
|------------------------------|--------------------------------------|-------------------------------------|--------------------------------------|-------------------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortized intangible assets: | | | | |
| Core deposit intangible | \$ 7,060,224 | (4,005,835) | \$ 7,060,224 | (3,306,347) |

The aggregate amortization expense of core deposit intangible subject to amortization for the three and nine-month periods ended September 30, 2007 and 2006 is as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------|---|-------------|--|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Aggregate amortization expense | \$ 222,849 | 249,369 | \$ 699,488 | 783,214 |

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The estimated amortization expense for the next five years is as follows:

| | |
|--|-----------|
| Estimated amortization expense: | |
| For the three months ending December, 2007 | \$222,849 |
| For year ending 2008 | 701,443 |
| For year ending 2009 | 626,111 |
| For year ending 2010 | 526,477 |
| For year ending 2011 | 434,763 |

Mortgage Servicing Rights

Mortgage loans serviced for others totaled approximately \$211,098,000 and \$219,161,000 at September 30, 2007 and 2006, respectively. Mortgage servicing rights totaled approximately \$1,230,000 and \$1,415,000 at September 30, 2007 and 2006, respectively. Mortgage servicing rights as a percentage of mortgage loans serviced have decreased as a result of an increase in prepayments of loans serviced.

Changes in the balance of servicing assets related to the loans serviced by The Exchange National Bank of Jefferson City for the periods indicated are as follows:

| | Nine Months Ended | |
|---|--------------------------|-------------|
| | September 30, | |
| | 2007 | 2006 |
| Balance, beginning of period | \$ 1,350,375 | 1,536,331 |
| Originated mortgage servicing rights | 217,975 | 192,849 |
| Amortization | (338,288) | (314,226) |
| Balance, end of period | \$ 1,230,062 | 1,414,954 |
| Mortgage loans serviced | \$ 211,098,203 | 219,160,535 |
| Mortgage servicing rights as a percentage of loans serviced | 0.58% | 0.65% |

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Our Company's mortgage servicing rights are amortized in proportion to the related estimated net servicing income over the estimated lives of the related mortgages, which is seven years. Changes in mortgage servicing rights, net of amortization, for the periods indicated are as follows:

| | |
|---|------------|
| Estimated amortization expense: | |
| For the three months ending December 31, 2007 | \$ 113,000 |
| For year ending 2008 | 290,000 |
| For year ending 2009 | 219,000 |
| For year ending 2010 | 147,000 |
| For year ending 2011 | 122,000 |

Income Taxes

On January 1, 2007, our Company adopted the provisions of FIN 48. As of January 1, 2007 our Company had \$1,015,000 of gross unrecognized tax benefits of which \$683,000 would impact the effective tax rate, if recognized. If these tax benefits are not recognized, the result would be cash tax payments. Our Company expects a reduction of \$234,000 in gross unrecognized tax benefits during the remaining three-month period ending December 31, 2007 as a result of the state statute of limitations closing for the 2003 tax year. The unrecognized tax benefits are related to various federal and state tax positions.

In addition, our Company accrues interest and, if applicable, penalties related to unrecognized tax positions as a component of income tax expense. As of January 1, 2007, interest accrued was approximately \$124,000.

Our Company and subsidiaries file income tax returns in the U. S. federal jurisdiction and the state of Missouri. Management believes the accrual for tax liabilities is adequate for all open audit years based on its assessment of many factors, including past experience and interpretations of tax law applied to the facts of each matter. This assessment relies on estimates and assumptions. Our Company's state income tax returns for 2003 to 2006 and federal income tax returns for 2004 to 2006 are open tax years. As of September 30, 2007, there were no federal or state income tax examinations in process.

Sale of Bank Charters

As a result of our Company's plan to consolidate our four bank subsidiaries under one charter, our Company sold the bank charter of Osage Valley Bank on March 16, 2007 for \$425,000 and the bank charter of Bank 10 on June 22, 2007 for \$450,000. These amounts are included in other noninterest income in the accompanying condensed consolidated financial statements.

Further, our Company sold the bank charter of Exchange National Bank for \$325,000 on October 5, 2007 and such amount will be recognized in other noninterest income in the fourth quarter. All bank subsidiaries have now been merged and are operating under the single bank charter of Hawthorn Bank.

Table of Contents**Defined Benefit Retirement Plan**

Our Company provides a noncontributory defined benefit pension plan for all full-time employees over the age of 21 who have completed at least one year of qualified service.

Pension expense for the periods indicated is as follows:

| | Estimated 2007 | Actual 2006 |
|--|---------------------------|------------------------|
| Service cost – benefits earned during the year | \$ 797,675 | \$ 620,564 |
| Interest cost on projected benefit obligations | 364,493 | 318,142 |
| Expected return on plan assets | (377,180) | (369,164) |
| Amortization of prior service cost | 78,628 | 78,628 |
| Amortization of net gains | (8,279) | (2,601) |
| | | |
| Pension expense – Annual | \$ 855,337 | \$ 645,569 |
| | | |
| Pension expense – three months ended September 30 (actual) | \$ 213,834 | \$ 166,760 |
| | | |
| Pension expense – nine months ended September 30 (actual) | \$ 641,502 | \$ 484,177 |

Under the provisions of the Pension Protection Act of 2006 our Company intends to make a contribution of approximately \$595,000 to the defined benefit pension plan during 2007.

Segment reporting

Through the respective branch network, Exchange National Bank and Hawthorn Bank provide similar products and services in two defined geographic areas. The products and services offered include 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. Loans include real estate, commercial, installment and other consumer loans. Other financial services include automatic teller machines, trust services, credit related insurance, and safe deposit boxes. The revenues generated by each business segment consist primarily of interest income, generated from the loan and debt and equity security portfolios, and service charges and fees, generated from the deposit products and services. The geographic areas are defined to be communities in central and western Missouri. The products and services are offered to customers primarily within their respective geographical areas. The business segments results that follow are consistent with our Company's internal reporting system which is consistent, in all material respects, with accounting principles generally accepted in the United States of America and practices prevalent in the banking industry.

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| | September 30, 2007 | | | |
|---|---|--------------------------|--------------------------------|----------------|
| | The Exchange National Bank of Jefferson City | Hawthorn Bank | Corporate and other | Total |
| Balance sheet information: | | | | |
| Loans, net of allowance for loan losses | \$ 378,635,657 | \$ 495,035,964 | \$ | \$ 873,671,621 |
| Debt and equity securities | 77,961,075 | 101,191,009 | 1,486,000 | 180,638,084 |
| Goodwill | 4,382,098 | 35,941,677 | | 40,323,775 |
| Intangible assets | | 3,054,389 | | 3,054,389 |
| Total assets | 505,582,753 | 692,305,601 | (12,273,747) | 1,185,614,607 |
| Deposits | 415,751,035 | 521,197,960 | (10,988,969) | 925,960,026 |
| Stockholders equity | \$ 52,396,366 | \$ 96,273,858 | \$ (38,537,992) | \$ 110,132,232 |

| | December 31, 2006 | | | |
|---|---|--------------------------|--------------------------------|----------------|
| | The Exchange National Bank of Jefferson City | Hawthorn Bank | Corporate and other | Total |
| Balance sheet information | | | | |
| Loans, net of allowance for loan losses | \$ 350,563,084 | \$ 452,734,297 | \$ | \$ 803,297,381 |
| Debt and equity securities | 85,177,657 | 103,109,653 | 1,486,000 | 189,773,310 |
| Goodwill | 4,382,098 | 35,941,677 | | 40,323,775 |
| Intangible assets | | 3,753,877 | | 3,753,877 |
| Total assets | 475,048,886 | 666,138,165 | 1,524,846 | 1,142,711,897 |
| Deposits | 384,413,021 | 524,228,167 | (8,776,454) | 899,864,734 |
| Stockholders equity | \$ 51,168,606 | \$ 83,080,439 | \$ (29,304,455) | \$ 104,944,590 |

Table of Contents**Three Months Ended September 30, 2007**

| | The Exchange National Bank of Jefferson City | Hawthorn Bank | Corporate and other | Total |
|---------------------------|---|--------------------------|--------------------------------|---------------|
| Statement of earnings: | | | | |
| Total interest income | \$ 8,676,071 | \$ 10,417,070 | \$ (100,974) | \$ 18,992,167 |
| Total interest expense | 3,819,706 | 5,090,551 | 756,669 | 9,666,926 |
| Net interest income | 4,856,365 | 5,326,519 | (857,643) | 9,325,241 |
| Provision for loan losses | 150,000 | 75,000 | | 225,000 |
| Noninterest income | 1,003,634 | 1,091,547 | | 2,095,181 |
| Noninterest expense | 2,902,584 | 4,646,197 | 612,392 | 8,161,173 |
| Income taxes | 915,050 | 455,196 | (472,984) | 897,262 |
| Net income (loss) | \$ 1,892,365 | \$ 1,241,673 | \$ (997,051) | \$ 2,136,987 |

Three Months Ended September 30, 2006

| | The Exchange National Bank of Jefferson City | Hawthorn Bank | Corporate and other | Total |
|---------------------------|---|--------------------------|--------------------------------|---------------|
| Statement of earnings: | | | | |
| Total interest income | \$ 8,209,775 | \$ 10,077,638 | \$ 27,052 | \$ 18,314,465 |
| Total interest expense | 3,430,944 | 4,266,113 | 892,405 | 8,589,462 |
| Net interest income | 4,778,831 | 5,811,525 | (865,353) | 9,725,003 |
| Provision for loan losses | 225,000 | 75,000 | | 300,000 |
| Noninterest income | 1,069,554 | 1,167,848 | (20,829) | 2,216,573 |
| Noninterest expense | 2,824,360 | 4,469,283 | 188,276 | 7,481,919 |
| Income taxes | 903,100 | 745,252 | (347,180) | 1,301,172 |
| Net income (loss) | \$ 1,895,925 | \$ 1,689,838 | \$ (727,278) | \$ 2,858,485 |

Table of Contents**Nine Months Ended September 30, 2007**

| | The Exchange National Bank of Jefferson City | Hawthorn Bank | Corporate and other | Total |
|---------------------------|---|--------------------------|--------------------------------|---------------|
| Statement of earnings: | | | | |
| Total interest income | \$ 24,845,038 | \$ 30,362,184 | \$ (47,200) | \$ 55,160,022 |
| Total interest expense | 10,826,546 | 14,279,901 | 2,507,617 | 27,614,064 |
| Net interest income | 14,018,492 | 16,082,283 | (2,554,817) | 27,545,958 |
| Provision for loan losses | 450,000 | 154,216 | | 604,216 |
| Noninterest income | 3,084,872 | 3,526,383 | 857,136 | 7,468,391 |
| Noninterest expense | 8,505,561 | 13,521,662 | 2,713,092 | 24,740,315 |
| Income taxes | 2,644,500 | 1,660,646 | (1,442,010) | 2,863,136 |
| Net income (loss) | \$ 5,503,303 | \$ 4,272,142 | \$ (2,968,763) | \$ 6,806,682 |

Nine Months Ended September 30, 2006

| | The Exchange National Bank of Jefferson City | Hawthorn Bank | Corporate and other | Total |
|---------------------------|---|--------------------------|--------------------------------|---------------|
| Statement of earnings: | | | | |
| Total interest income | \$ 24,040,166 | \$ 28,918,413 | \$ 78,573 | \$ 53,037,152 |
| Total interest expense | 9,805,051 | 11,644,888 | 2,569,115 | 24,019,054 |
| Net interest income | 14,235,115 | 17,273,525 | (2,490,542) | 29,018,098 |
| Provision for loan losses | 675,000 | 253,000 | | 928,000 |
| Noninterest income | 3,151,596 | 3,397,817 | (57,749) | 6,491,664 |
| Noninterest expense | 8,583,106 | 13,145,581 | 522,291 | 22,250,978 |
| Income taxes | 2,618,700 | 2,226,777 | (994,970) | 3,850,507 |
| Net income (loss) | \$ 5,509,905 | \$ 5,045,984 | \$ (2,075,612) | \$ 8,480,277 |

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

Forward-Looking Statements

Except for the historical information contained herein, the statements made in this report on form 10-Q are forward-looking statements that involve risks and uncertainties. The words should, expect, anticipate, believe, may, hope, forecast and similar expressions may identify forward looking statements.

In particular, statements concerning our Company's ability to expand its presence in the Kansas City, Missouri metropolitan market, concerning our expected contributions to any of our bank's benefit plans, concerning our amortization of core deposit intangibles or other assets, concerning our intent and ability to hold securities until maturity, that the periodic review of our loan portfolio keeps management informed of possible loan problems and that the allowance for loan losses adequately covers any exposure on specific credits are all forward-looking statements.

Our Company's actual results, financial condition, or business could differ materially from its historical results, financial condition, or business, or from the results of operations, financial condition, or business contemplated by such forward-looking statements. Factors that may cause actual results to differ materially from those contemplated by the forward-looking statements herein include market conditions as well as conditions specifically affecting the banking industry generally and factors having a specific impact on our Company including, but not limited to, fluctuations in interest rates and in the economy; the impact of laws and regulations applicable to our Company and changes therein; competitive conditions in the markets in which our Company conducts its operations, including competition from banking and non-banking companies with substantially greater resources than our Company, some of which may offer and develop products and services not offered by our Company; and the ability of our Company to respond to changes in technology.

Additional factors that could cause or contribute to such differences were discussed under the caption Factors that may affect future results of operations, financial condition, or business, in our Company's annual report on form 10-K for the year ended December 31, 2006, as well as those discussed elsewhere in our Company's reports filed with the Securities and Exchange Commission.

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Overview

This overview of management's discussion and analysis highlights selected information in this report and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources and critical accounting estimates, you should carefully read this entire report. These have an impact on our Company's financial condition and results of operation.

Business Strategy: On December 1, 2006, our Company announced its development of a strategic plan. The plan included consolidating Exchange National Bank, Citizens Union State Bank, Osage Valley Bank and Bank 10 into a single bank under a Missouri state trust charter. The plan also included the selection of a new name for our Company and the combined subsidiary banks. Management believes the re-branding of the consolidated bank under a single name and logo eliminates any confusion that comes from operating under four separate bank identities and distinguishes our Company from any other bank in Missouri and the central states region.

On March 16, 2007 Osage Valley Bank and Citizens Union State Bank were combined. On April 20, 2007, our Company issued a press release announcing that Hawthorn Bank had been selected as the new name for its combined subsidiary banks. As of April 23, 2007 Citizens Union State Bank began using the name Hawthorn Bank. At the June 13, 2007 annual board meeting our Company's shareholders approved to change our name from Exchange National Bancshares, Inc. to Hawthorn Bancshares, Inc. On June 22, 2007 Hawthorn Bank and Bank 10 were combined. Management completed the consolidation process on October 5, 2007 when Exchange National Bank combined with Hawthorn Bank. At this time the charter was relocated from Clinton to Jefferson City, Missouri.

Material Challenges and Risks: Our Company may experience difficulties managing growth and effectively integrating newly established branches. As part of our general strategy, our Company may continue to acquire banks and establish de novo branches that we believe provide a strategic fit. To the extent that our Company does grow, there can be no assurances that we will be able to adequately and profitably manage such growth. The successes of our Company's growth strategy will depend primarily on the ability of our banking subsidiaries 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. Our Company's financial performance also depends, in part, on our ability to manage various portfolios and to successfully introduce additional financial products and services. Furthermore, the success of our Company's growth strategy will depend on our ability to maintain sufficient regulatory capital levels and on general economic conditions that are beyond our control.

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Revenue Source: Through the respective branch network, Exchange National Bank and Hawthorn Bank provide similar products and services in two defined geographic areas. The products and services offered include 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. Loans include real estate, commercial, installment, and other consumer loans. Other financial services include automatic teller machines, trust services, credit related insurance, and safe deposit boxes. The revenues generated by each business segment consist primarily of interest income, generated primarily from the loan and debt and equity security portfolios, and service charges and fees, generated from the deposit products and services. The geographic areas are defined to be communities in central and western Missouri. The products and services are offered to customers primarily within their respective geographical areas. The business segment results are consistent with our Company's internal reporting system which is consistent, in all material respects, with generally accepted accounting principles and practices prevalent in the banking industry.

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

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

Our Company has prepared the unaudited condensed consolidated financial statements 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, our 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.

Critical Accounting Policies: The impact and any associated risks related to the Company's critical accounting policies on business operations are discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations, where such policies affect our reported and expected financial results. For a detailed discussion on the application of these and other accounting policies, see the Company's Annual Report on Form 10-K for the year ended December 31, 2006. Management believes there have been no material changes to our critical accounting policies.

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Results of Operations

Net income for the three months ended September 30, 2007 of \$2,137,000 decreased \$721,000 when compared to the third quarter of 2006. Diluted earnings per common share for the third quarter of 2007 of \$0.51 decreased \$0.17 or 25.0% when compared to the third quarter of 2006.

Net income for the nine months ended September 30, 2007 of \$6,807,000 decreased \$1,674,000 when compared to the same period in 2006. Diluted earnings per common share for the first nine months of 2007 of \$1.61 decreased \$0.41 or 20.3% when compared to the same period in 2006.

Net interest income (on a tax equivalent basis) was \$9,571,000, or 3.60% of average earning assets, for the three months ended September 30, 2007, compared to \$9,973,000, or 3.83% of average earning assets, for the same period in 2006. While the yield on earning assets increased 10 basis points from 7.14% for the three months ended September 30, 2006 to 7.24% for the three months ended September 30, 2007, the average rate paid on interest-bearing liabilities increased 36 basis points from 3.78% for the three months ended September 30, 2006 to 4.14% for the three months ended September 30, 2007.

Net interest income (on a tax equivalent basis) was \$28,277,000, or 3.67% of average earning assets, for the nine months ended September 30, 2007, compared to \$29,769,000, or 3.85% of average earning assets, for the same period in 2006. While the yield on earning assets increased 29 basis points from 6.96% for the nine months ended September 30, 2006 to 7.25% for the nine months ended September 30, 2007, the average rate paid on interest-bearing liabilities increased 54 basis points from 3.54% for the nine months ended September 30, 2006 to 4.08% for the nine months ended September 30, 2007.

The increase in average rates paid on interest-bearing liabilities during the three and nine month periods indicated above, reflect both higher rates paid on borrowed funds and higher rates paid on deposits that are a result of competitive pressures in our market place.

Fully taxable equivalent net interest income decreased \$402,000 or 4.0% and \$1,492,000 or 5.0% for the three and nine month periods ended September 30, 2007 compared to the same period in 2006. The decrease in net interest income for the periods ended September 30, 2007 compared to the periods ended September 30, 2006 was the result of both decreased earning assets and decreased net interest margin. Management anticipates that our Company will continue to experience downward pressure on our net interest margin in the near future due to the competitive environment in which we operate.

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Average Balance Sheets

Average interest-earning assets for the three months ended September 30, 2007 were \$1,054,179,000, an increase of \$22,074,000 or 2.1%, compared to average interest-earning assets of \$1,032,105,000 for the same period of 2006. Average loans outstanding increased approximately \$40,821,000 while other earning assets decreased \$18,747,000. The decrease in other earning assets reflects the use of maturing investments and federal funds sold to fund the increase in loans.

Average interest-earning assets for the nine months ended September 30, 2007 were \$1,030,258,000, a decrease of \$2,678,000 or 0.26%, compared to average interest-earning assets of \$1,032,936,000 for the same period of 2006. Average loans outstanding increased approximately \$7,801,000 while other earning assets decreased \$10,479,000. The decrease in other earning assets reflects the use of maturing investments to fund the increase in loans.

The following table sets for information regarding average daily balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resultant yields, interest rate spread, net interest margin, and the ratio of average interest-earning assets to average interest-bearing liabilities for the periods indicated.

Table of Contents*(Dollars expressed in thousands)*

| | Three Months Ended | | | | | |
|--|--------------------|-------------------------------------|--------------------|--------------------|-------------------------------------|--------------------|
| | September 30, 2007 | | | September 30, 2006 | | |
| | Average | Interest and Dividends /1/ | Yield / Cost | Average | Interest and Dividends /1/ | Yield / Cost |
| | Balance | | | Balance | | |
| ASSETS | | | | | | |
| Loans: ^{2/} ^{3/} | \$ 869,669 | \$ 16,920 | 7.72% | \$ 828,848 | \$ 16,101 | 7.71% |
| Investment in debt and equity securities : ^{4/} | | | | | | |
| Government sponsored enterprises | 118,532 | 1,428 | 4.78 | 125,463 | 1,420 | 4.49 |
| State and municipal | 53,922 | 739 | 5.44 | 52,924 | 718 | 5.38 |
| Other | 6,014 | 65 | 4.29 | 6,650 | 83 | 4.95 |
| Federal funds sold | 5,331 | 78 | 5.80 | 16,613 | 221 | 5.28 |
| Interest-bearing deposits | 711 | 8 | 4.46 | 1,607 | 19 | 4.69 |
| | | | | | | |
| Total interest earning assets | 1,054,179 | 19,238 | 7.24 | 1,032,105 | 18,562 | 7.14 |
| | | | | | | |
| All other assets | 129,614 | | | 124,628 | | |
| Allowance for loan losses | (9,139) | | | (9,321) | | |
| | | | | | | |
| Total assets | \$ 1,174,654 | | | \$ 1,147,412 | | |
| | | | | | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | |
| NOW accounts | \$ 117,905 | \$ 417 | 1.40% | \$ 102,521 | \$ 323 | 1.25% |
| Savings accounts | 46,219 | 64 | 0.55 | 50,779 | 73 | 0.57 |
| Money market | 163,540 | 1,525 | 3.70 | 158,797 | 1,378 | 3.44 |
| Deposits of \$100 and over | 132,360 | 1,659 | 4.97 | 126,220 | 1,420 | 4.46 |
| Other time deposits | 327,542 | 3,904 | 4.73 | 317,542 | 3,262 | 4.08 |
| | | | | | | |
| Total time deposits | 787,566 | 7,569 | 3.81 | 755,859 | 6,456 | 3.39 |
| Federal funds purchased and securities sold under agreements to repurchase | 34,464 | 427 | 4.92 | 40,304 | 462 | 4.55 |
| Interest-bearing demand notes to US Treasury | 2 | | | 763 | 9 | 4.68 |
| Subordinated notes | 49,486 | 907 | 7.27 | 49,486 | 912 | 7.31 |
| Advances from Federal Home Loan Bank | 55,924 | 764 | 5.42 | 55,468 | 750 | 5.36 |

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| | | | | | | |
|--|--------------|----------|-------|--------------|----------|-------|
| Total interest-bearing liabilities | 927,442 | 9,667 | 4.14 | 901,880 | 8,589 | 3.78 |
| Demand deposits | 127,857 | | | 134,539 | | |
| Other liabilities | 10,558 | | | 9,656 | | |
| Total liabilities | 1,065,857 | | | 1,046,075 | | |
| Stockholders' equity | 108,797 | | | 101,337 | | |
| Total liabilities and stockholders' equity | \$ 1,174,654 | | | \$ 1,147,412 | | |
| Net interest income | | \$ 9,571 | | | \$ 9,973 | |
| Net interest margin ^{/5/} | | | 3.60% | | | 3.83% |

/1/ Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 35%, net of nondeductible interest expense. Such adjustments totaled \$246,000 in 2007 and \$248,000 in 2006.

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

/3/ Fees on loans are included in average amounts outstanding.

- /4/ Average balances based on amortized cost.
- /5/ Net interest income divided by average total interest earning assets.

Table of Contents*(Dollars expressed in thousands)*

| | Nine Months Ended | | | | | |
|--|--------------------|------------------------------|----------------|--------------------|------------------------------|----------------|
| | September 30, 2007 | | | September 30, 2006 | | |
| | Average | Interest and Dividends | Yield/ Cost | Average | Interest and Dividends | Yield/ Cost |
| | Balance | /1/ | /1/ | Balance | /1/ | /1/ |
| ASSETS | | | | | | |
| Loans: ^{2/} ^{3/} | \$ 834,445 | \$ 48,489 | 7.77% | \$ 826,644 | \$ 46,654 | 7.55% |
| Investment in debt and equity securities : ^{4/} | | | | | | |
| Government sponsored enterprises | 120,818 | 4,346 | 4.81 | 129,766 | 4,139 | 4.26 |
| State and municipal | 54,175 | 2,223 | 5.49 | 53,042 | 2,159 | 5.44 |
| Other | 6,143 | 243 | 5.29 | 6,968 | 231 | 4.43 |
| Federal funds sold | 13,272 | 536 | 5.40 | 14,204 | 529 | 4.98 |
| Interest-bearing deposits | 1,405 | 54 | 5.14 | 2,312 | 76 | 4.40 |
| | | | | | | |
| Total interest earning assets | 1,030,258 | 55,891 | 7.25 | 1,032,936 | 53,788 | 6.96 |
| | | | | | | |
| All other assets | 127,054 | | | 123,532 | | |
| Allowance for loan losses | (9,093) | | | (9,267) | | |
| | | | | | | |
| Total assets | \$ 1,148,219 | | | \$ 1,147,201 | | |
| | | | | | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | |
| NOW accounts | \$ 109,494 | \$ 1,078 | 1.32% | \$ 109,034 | \$ 1,104 | 1.35% |
| Savings accounts | 47,505 | 200 | 0.56 | 53,113 | 227 | 0.57 |
| Money market | 156,402 | 4,203 | 3.59 | 156,701 | 3,770 | 3.22 |
| Deposits of \$100 and over | 137,711 | 5,085 | 4.94 | 119,487 | 3,686 | 4.12 |
| Other time deposits | 320,482 | 11,163 | 4.66 | 313,533 | 8,969 | 3.82 |
| | | | | | | |
| Total time deposits | 771,594 | 21,729 | 3.77 | 751,868 | 17,756 | 3.16 |
| Federal funds purchased and securities sold under agreements to repurchase | 32,708 | 1,131 | 4.62 | 45,885 | 1,459 | 4.25 |
| Interest-bearing demand notes to US Treasury | 274 | 11 | 5.37 | 655 | 22 | 4.49 |
| Subordinated notes | 49,486 | 2,698 | 7.29 | 49,486 | 2,628 | 7.10 |
| Advances from Federal Home Loan Bank | 50,222 | 2,045 | 5.44 | 59,270 | 2,154 | 4.86 |
| | | | | | | |
| | 904,284 | 27,614 | 4.08 | 907,164 | 24,019 | 3.54 |

| | | | |
|---|--------------|-----------|--------------|
| Total interest-bearing liabilities | | | |
| Demand deposits | 126,766 | | 131,872 |
| Other liabilities | 10,145 | | 8,823 |
| Total liabilities | 1,041,195 | | 1,047,859 |
| Stockholders' equity | 107,024 | | 99,693 |
| Total liabilities and stockholders' equity | \$ 1,148,219 | | \$ 1,147,552 |
| Net interest income | | \$ 28,277 | \$ 29,769 |
| Net interest margin ^{/5/} | | 3.67% | 3.85% |
| <p>^{/1/} Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate of 35%, net of nondeductible interest expense. Such adjustments totaled \$731,000 in 2007 and \$751,000 in 2006.</p> | | | |
| <p>^{/2/} Non-accruing loans are included in the average amounts outstanding.</p> | | | |
| <p>^{/3/} Fees on loans are included in average amounts outstanding.</p> | | | |

- /4/ Average balances based on amortized cost.
- /5/ Net interest income divided by average total interest earning assets.

Table of Contents**Rate Volume Analysis**

The following table presents, on a fully taxable equivalent basis, an analysis of changes in net interest income resulting from changes in average volumes of earning assets and interest bearing liabilities and average rates earned and paid. The change in interest due to the combined rate/volume variance has been allocated to rate and volume changes in proportion to the absolute dollar amounts of change in each.

Dollars expressed in thousands)

| | Three Months Ended | | | Nine Months Ended | | |
|--|----------------------------|----------|--------|----------------------------|----------|---------|
| | Compared to | | | Compared to | | |
| | September 30, 2007 vs 2006 | | | September 30, 2007 vs 2006 | | |
| Total | Change due to | | Total | Change due to | | |
| Change | Volume | Rate /4/ | Change | Volume | Rate /4/ | |
| | /3/ | | | /3/ | | |
| Interest income on a fully taxable equivalent basis: | | | | | | |
| Loans:/1/ | \$ 819 | 794 | 25 | \$ 1,835 | 444 | 1,391 |
| Investment in debt and equity securities :/3/ | | | | | | |
| Government sponsored enterprises | 8 | (80) | 88 | 207 | (298) | 505 |
| State and municipal | 21 | 14 | 7 | 64 | 46 | 18 |
| Other | (18) | (8) | (10) | 12 | (29) | 41 |
| Federal funds sold | (143) | (163) | 20 | 7 | (36) | 43 |
| Interest-bearing deposits | (11) | (10) | (1) | (22) | (33) | 11 |
| Total interest income | 676 | 547 | 129 | 2,103 | 94 | 2,009 |
| Interest expense: | | | | | | |
| NOW accounts | \$ 94 | 51 | 43 | \$ (26) | 5 | (31) |
| Savings accounts | (9) | (7) | (2) | (27) | (24) | (3) |
| Money market | 147 | 42 | 105 | 433 | (7) | 440 |
| Deposits of \$100 and over | 239 | 71 | 168 | 1,399 | 610 | 789 |
| Other time deposits | 642 | 106 | 536 | 2,194 | 203 | 1,991 |
| Federal funds purchased and securities sold under agreements to repurchase | (35) | (70) | 35 | (328) | (447) | 119 |
| Interest-bearing demand notes of U.S. Treasury | (9) | (4) | (5) | (11) | (15) | 4 |
| Subordinated debentures | (5) | | (5) | 70 | | 70 |
| Other borrowed money | 14 | 6 | 8 | (109) | (351) | 242 |
| Total interest expense | 1,078 | 195 | 883 | 3,595 | (26) | 3,621 |
| Net interest income on a fully taxable equivalent basis | \$ (402) | 352 | (754) | \$ (1,492) | 120 | (1,612) |

- /1/ Interest income and yields are presented on a fully taxable equivalent basis using the Federal statutory income tax rate. Such adjustments were \$246,000 and \$248,000 for the three months ended 2007 and 2006, respectively. Such adjustments were \$731,000 and \$751,000 for the nine months ended 2007 and 2006, respectively.
- /2/ Non-accruing loans are included in the average amounts outstanding.
- /3/ Change in volume multiplied by yield/rate of prior period.
- /4/ Change in yield/rate multiplied by volume of prior period.

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THREE MONTHS ENDED SEPTEMBER 30, 2007 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2006

Our Company's primary source of earnings is net interest income, which is the difference between the interest earned on interest earning assets and the interest paid on interest bearing liabilities. Net interest income on a fully taxable equivalent basis decreased \$402,000 or 4.0% to \$9,571,000 or 3.6% of average earning assets for the third quarter of 2007 compared to \$9,973,000 or 3.8% of average earning assets for the same period of 2006. The provision for loan losses was \$225,000 and \$300,000 for the three months ended September 30, 2007 and 2006 respectively. Net charge-offs were \$118,000 for the third quarter of 2007 compared to \$253,000 for the third quarter of 2006. The decrease in the provision for loan losses for the third quarter of 2007 compared to third quarter 2006 reflects the expected loss in the loan portfolio based upon managements' analysis of the risk in the portfolio. See Lending and Credit Management in this report for further discussion of third quarter 2007 charge-offs.

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Noninterest income and noninterest expense for the three-month periods ended September 30, 2007 and 2006 were as follows:

(Dollars expressed in thousands)

| | Three Months Ended | | Increase (decrease) | |
|---|-----------------------|----------|---------------------|---------|
| | September 30, 2007 | 2006 | Amount | % |
| Noninterest Income | | | | |
| Service charges on deposit accounts | \$ 1,307 | \$ 1,462 | \$ (155) | (10.6)% |
| Trust department income | 201 | 215 | (14) | (6.5) |
| Mortgage loan servicing fees, net | 60 | 102 | (42) | (41.2) |
| Gain on sale of mortgage loans | 159 | 127 | 32 | 25.2 |
| Other | 368 | 311 | 57 | 18.3 |
| | \$ 2,095 | \$ 2,217 | \$ (122) | (5.5)% |
| Noninterest Expense | | | | |
| Salaries and employee benefits | \$ 4,484 | \$ 4,254 | \$ 230 | 5.4% |
| Occupancy expense | 574 | 500 | 74 | 14.8 |
| Furniture and equipment expense | 638 | 592 | 46 | 7.8 |
| Advertising and promotion | 273 | 234 | 39 | 16.7 |
| Postage, printing and supplies | 364 | 277 | 87 | 31.4 |
| Legal, examination, and professional fees | 292 | 334 | (42) | (12.6) |
| Processing expense | 325 | 261 | 64 | 24.5 |
| Amortization CDI | 223 | 249 | (26) | (10.4) |
| Other | 988 | 781 | 207 | 26.5 |
| | \$ 8,161 | \$ 7,482 | \$ 679 | 9.1% |

Noninterest income decreased \$122,000 or 5.5% to \$2,095,000 for the third quarter of 2007 compared to \$2,217,000 for the same period of 2006. Service charges on deposit accounts decreased \$155,000 or 10.6% as a result of decreased overdraft and insufficient check fee income, ATM fee income, and debit card fee income. Mortgage loan servicing fees decreased \$42,000 or 41.2% to \$60,000 compared to \$102,000 as a result in a decrease in the amount of mortgage loans serviced. Our Company is servicing \$211,098,000 of mortgage loans at September 30, 2007 compared to \$219,161,000 at September 30, 2006. Gain on sale of mortgage loans increased \$32,000 or 25.2% due to an increase in volume of loans originated and sold to the secondary market from approximately \$4,415,000 in the third quarter of 2006 to approximately \$7,549,000 for the third quarter of 2007. Even though the volume of loans originated and sold has increased over the comparable period in the prior year our total loan servicing portfolio is declining due to both increased prepayments of existing loans and an increase in the volume of loans that are being sold without retaining the servicing rights.

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Noninterest expense increased \$679,000 or 9.1% to \$8,161,000 for the third quarter of 2007 compared to \$7,482,000 for the third quarter of 2006. Salaries and benefits increased \$230,000 or 5.4%, occupancy expense increased \$74,000 or 14.8%, advertising and promotion increased \$39,000 or 16.7%, postage, printing and supplies increased \$87,000 or 31.4%, processing expense increased \$64,000 or 24.5% and other noninterest expense increased \$207,000 or 26.5%. Salaries and employees benefits reflect a \$303,000 decrease in management's estimate of anticipated incentive payments and profit sharing contributions compared to the same period in the prior year. Excluding this decrease, salaries and employees benefits increased \$533,000 or 13.9%. The increase reflects normal salary increases, additional personnel resulting from staffing for a newly opened branch facility in Columbia, Missouri and additional holding company personnel required for the implementation of our Company's strategic plan. The \$74,000 increase in occupancy expense reflects increased costs in opening new branch facilities in Columbia and Clinton. The \$39,000 increase in advertising and promotion and the \$87,000 increase in postage, printing, and supplies reflect nonrecurring costs associated with the re-branding of our Company's name and logo. The \$64,000 or 24.5% increase in processing expense reflects nonrecurring costs associated with the merger of the bank subsidiaries and software and network conversion. The \$207,000 net increase in other noninterest expense reflects expenses in various other categories including, but not limited to, higher telephone and internet costs, correspondent bank charges, meals & entertainment, loan collection expenses and conversion costs partially offset by directors' fees and donations.

Income taxes as a percentage of earnings before income taxes as reported in the condensed consolidated financial statements were 29.6% for the third quarter of 2007 compared to 31.3% for the third quarter of 2006. The decrease in the effective income tax rate reflects a reduction in income subject to state bank taxes.

NINE MONTHS ENDED SEPTEMBER 30, 2007 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2006

Our Company's primary source of earnings is net interest income, which is the difference between the interest earned on interest earning assets and the interest paid on interest bearing liabilities. Net interest income on a fully taxable equivalent basis decreased \$1,492,000 or 5.0% to \$28,277,000 or 3.7% of average earning assets for the first nine months ended of 2007 compared to \$29,769,000 or 3.9% of average earning assets for the same period of 2006. The provision for loan losses was \$604,000 and \$928,000 for the nine months ended September 30, 2007 and 2006 respectively. Net charge-offs were \$401,000 for the first nine months of 2007 compared to \$631,000 for the same period in 2006. The decrease in the provision for loan losses for the first nine months of 2007 compared to first nine months of 2006 reflects the expected loss in the loan portfolio based upon managements' analysis of the risk in the portfolio. See Lending and Credit Management in this report for further discussion of third quarter 2007 charge-offs.

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Noninterest income and noninterest expense for the nine-month periods ended September 30, 2007 and 2006 were as follows:

(Dollars expressed in thousands)

| | Nine Months Ended | | Increase (decrease) | |
|--|-------------------------------|------------------|----------------------------|--------------|
| | September 30, 2007 | 2006 | Amount | % |
| Noninterest Income | | | | |
| Service charges on deposit accounts | \$ 3,893 | \$ 4,339 | \$ (446) | (10.3)% |
| Trust department income | 629 | 623 | 6 | 1.0 |
| Mortgage loan servicing fees, net | 250 | 327 | (77) | (23.5) |
| Gain on sale of mortgage loans | 501 | 328 | 173 | 52.7 |
| Loss on sales and calls of debt securities | (2) | (18) | 16 | (88.9) |
| Other | 2,197 | 893 | 1,304 | 146.0 |
| | \$ 7,468 | \$ 6,492 | \$ 976 | 15.0% |
| Noninterest Expense | | | | |
| Salaries and employee benefits | \$ 14,154 | \$ 12,942 | \$ 1,212 | 9.4% |
| Occupancy expense | 1,566 | 1,400 | 166 | 11.9 |
| Furniture and equipment expense | 1,797 | 1,654 | 143 | 8.6 |
| Advertising and promotion | 702 | 622 | 80 | 12.9 |
| Postage, printing and supplies | 923 | 861 | 62 | 7.2 |
| Legal, examination, and professional fees | 1,203 | 947 | 256 | 27.0 |
| Processing expense | 879 | 776 | 103 | 13.3 |
| Amortization CDI | 699 | 783 | (84) | (10.7) |
| Other | 2,817 | 2,266 | 551 | 24.3 |
| | \$ 24,740 | \$ 22,251 | \$ 2,489 | 11.2% |

Noninterest income increased \$976,000 or 15.0% to \$7,468,000 for the first nine months of 2007 compared to \$6,492,000 for the same period of 2006. Service charges on deposit accounts decreased \$446,000 or 10.3% as a result of decreased overdraft and insufficient check fee income, ATM fee income, and debit card fee income. Mortgage loan servicing fees decreased \$77,000 or 23.5% to \$250,000 compared to \$327,000 as a result in a decrease in the amount of mortgage loans serviced. Our Company is servicing \$211,098,000 of mortgage loans at September 30, 2007 compared to \$219,161,000 at September 30, 2006. Gain on sale of mortgage loans increased \$173,000 or 52.7% due to an increase in volume of loans originated and sold to the secondary market from approximately \$16,508,000 in the first nine months of 2006 to approximately \$24,057,000 for the first nine months of 2007. Even though the volume of loans originated and sold has increased over the comparable period in the prior year our total loan servicing portfolio is declining due to both increased prepayments of existing loans and an

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increase in the volume of loans that are being sold without retaining the servicing rights. Our Company recognized \$2,000 in loss on sales and calls of debt securities during the third quarter of 2007 versus losses of \$18,000 during the third quarter of 2006. Other noninterest income increased \$1,304,000 or 146.0%. \$875,000 of the increase represents the amount received from the sale of Osage Valley Bank and Bank 10's state bank charter and \$254,000 of the increase reflects recovery of prior years' legal costs as a result of settlement of a lawsuit in our Company's favor.

Noninterest expense increased \$2,489,000 or 11.2% to \$24,740,000 for the first nine months of 2007 compared to \$22,251,000 for the first nine months of 2006. Salaries and benefits increased \$1,212,000 or 9.4%, occupancy expense increased \$166,000 or 11.9%, furniture and equipment expense increased \$143,000 or 8.6%, advertising and promotion increased \$80,000 or 12.9%, legal, examination, and professional fees increased \$256,000 or 27.0%, processing expense increased \$103,000 or 13.3%, and other noninterest expense increased \$551,000 or 24.3%. Salaries and employees benefits reflect a \$309,000 decrease in management's estimate of anticipated incentive payments and profit sharing contributions compared to the same period in the prior year. Excluding this decrease, salaries and employees benefits increased \$1,521,000 or 11.6%. The increase reflects normal salary increases, additional personnel resulting from staffing for a newly opened branch facility, in Columbia, Missouri, and additional holding company personnel required for the implementation of our Company's strategic plan. The \$166,000 and \$143,000 increase in occupancy expense and furniture and equipment expense reflects increased costs in opening new branch facilities in Columbia and Clinton. The \$80,000 increase in advertising and promotion reflects nonrecurring costs associated with the re-branding of our Company's name and logo. The \$256,000 increase in legal, examination, and professional fees reflects costs incurred during the re-branding and merger of Hawthorn Bank and Bank 10. The \$103,000 or 13.3% increase in processing expense reflects nonrecurring costs associated with the merger of the bank subsidiaries and software and network conversion. The \$551,000 net increase in other noninterest expense reflects expenses in various other categories including, but not limited to, higher directors fees, travel, telephone and internet, meals & entertainment, loan collection expenses, conversion costs and other insurance partially offset by lower expenses in correspondent bank charges, donations, and dues.

Income taxes as a percentage of earnings before income taxes as reported in the condensed consolidated financial statements were 29.6% for the first nine months of 2007 compared to 31.2% for the first nine months of 2006. The decrease in the effective income tax rate reflects a reduction in income subject to state bank taxes.

Lending and Credit Management

Interest earned on the loan portfolio is a primary source of interest income for our Company. Net loans represented 73.7% of total assets as of September 30, 2007 compared to 70.3% as of December 31, 2006 and 70.6% as of September 30, 2006.

Lending activities are conducted pursuant to written loan policies approved by our Banks' Boards of Directors. Larger credits are reviewed by our Banks' Discount Committees. These committees are comprised of members of senior management.

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Our Company generally does not retain long-term fixed rate residential mortgage loans in its portfolio. Fixed rate loans conforming to standards required by the secondary market are offered to qualified borrowers, but are not funded until our Company has a non-recourse purchase commitment from the secondary market at a predetermined price. At September 30, 2007, our Company was servicing approximately \$211,098,000 of loans sold to the secondary market.

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

The provision for loan losses is based on management's evaluation of the loan portfolio in light of national and local economic conditions, changes in the composition and volume of the loan portfolio, changes in the volume of past due and nonaccrual loans, value of underlying collateral and other relevant factors. The allowance for loan losses which is reported as a deduction from loans is available for loan charge-offs. This allowance is increased by the provision charged to expense and is reduced by loan charge-offs net of loan recoveries. Management formally reviews all loans in excess of certain dollar amounts (periodically established) at least annually. In addition, on a monthly basis, management reviews past due, classified, and watch list loans in order to classify or reclassify loans as loans requiring attention, substandard, doubtful, or loss. During that review, management also determines which loans should be considered to be impaired. Management follows the guidance provided in Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, (SFAS 114) in identifying and measuring loan impairment. If management determines that it is probable that all amounts due on a loan will not be collected under the original terms of the loan agreement, the loan is considered to be impaired. Once a loan has been identified as impaired management generally measures impairment based upon the fair value of the underlying collateral. Management believes, but there can be no assurance, that these procedures keep management informed of possible problem loans. Based upon these procedures, both the allowance and provision for loan losses are adjusted to maintain the allowance at a level considered adequate by management for probable losses inherent in the loan portfolio.

The allowance for loan losses was decreased by net loan charge-offs of \$77,000, \$207,000, and 118,000 for the first, second and third quarters of 2007 compared to \$17,000, \$361,000, and \$253,000, respectively for the first, second and third quarters of 2006. The allowance for loan losses was increased by a provision charged to expense of \$225,000 for the first quarter of 2007, \$154,000 for the second quarter, and \$225,000 for the third quarter of 2007. That compares to a provision of \$318,000 for the first quarter, \$310,000 for the second quarter, and \$300,000 for the third quarter of 2006, respectively.

The balance of the allowance for loan losses was \$9,218,000 at September 30, 2007 compared to \$9,015,000 at December 31, 2006 and \$9,381,000 at September 30, 2006. The allowance for loan losses as a percent of outstanding loans was 1.04% at September 30, 2007 compared to 1.11% at December 31, 2006 and 1.14% at September 30, 2006. Based upon an analysis of the probable losses in the loan portfolio management believes the current balance of the allowance for loan losses is at an adequate level.

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Nonperforming loans, defined as loans on nonaccrual status, loans 90 days or more past due and still accruing, and restructured loans totaled \$5,696,000 or 0.65% of total loans at September 30, 2007 compared to \$5,066,000 or 0.62% of total loans at December 31, 2006. Detail of those balances plus other real estate and repossessions is as follows:

(Dollars expressed in thousands)

| | September 30, 2007 | | December 31, 2006 | |
|--|---------------------------|---------------------------------|--------------------------|---------------------------------|
| | Balance | % of Gross Loans | Balance | % of Gross Loans |
| Nonaccrual loans: | | | | |
| Commercial | \$ 2,991 | 0.35% | \$ 2,495 | 0.31% |
| Real estate: | | | | |
| Construction | 909 | 0.10 | 1,657 | 0.20 |
| Mortgage | 647 | 0.07 | 644 | 0.08 |
| Consumer | 43 | | 73 | 0.01 |
| | 4,590 | 0.52 | 4,869 | 0.60 |
| Loans contractually past-due 90 days or more and still accruing: | | | | |
| Commercial | 101 | 0.01 | 5 | |
| Real estate: | | | | |
| Construction | 20 | 0.01 | | |
| Mortgage | 962 | 0.11 | 170 | 0.02 |
| Consumer | 23 | | 22 | |
| | 1,106 | 0.13 | 197 | 0.02 |
| Restructured loans | | | | |
| Total nonperforming loans | 5,696 | 0.65% | 5,066 | 0.62% |
| Other real estate | 4,730 | | 2,720 | |
| Repossessions | | | 15 | |
| Total nonperforming assets | \$ 10,426 | | \$ 7,801 | |

The allowance for loan losses was 161.8% of nonperforming loans at September 30, 2007 compared to 177.9% of nonperforming loans at December 31, 2006. The \$2,000,000 increase in other real estate since December 31, 2006 represents the foreclosure on approximately twenty speculative homes in the Kansas City, Missouri area. Our Company has contracts for the sales of approximately half of these properties and expect no additional loss from those sales.

It is our Company's policy to discontinue the accrual of interest income on loans when the full collection of interest or principal is in doubt, or when the payment of interest or principal has become contractually 90 days past due unless the obligation is both well secured and in the process of collection. A loan remains on nonaccrual status until the loan is current as to payment of both principal and interest and/or the borrower demonstrates the ability to pay and remain current. Interest on loans on nonaccrual status which would have been recorded under the original terms of those loans

was approximately \$565,000 and \$764,000 for the nine months ended September 30, 2007 and 2006, respectively. Approximately \$347,000 and \$35,000 was recorded as interest income on such loans for the nine months ended September 30, 2007 and 2006, respectively.

A loan is considered impaired when it is probable a creditor will be unable to collect all amounts due both principal and interest according to the contractual terms of the loan agreement. In addition to nonaccrual loans included in the table above, which were considered

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impaired, management has identified approximately \$4,101,000 of additional loans as being impaired at September 30, 2007. The average balance of nonaccrual and other impaired loans for the first nine months of 2007 was approximately \$9,059,000. At December 31, 2006 the balance of nonaccrual and other impaired loans was \$14,053,000. At September 30, 2007 the portion of the allowance for loan losses allocated (both asset-specific and percentage) to impaired loans was \$3,115,000 compared to \$3,287,000 at December 31, 2006. The balance of impaired loans with no specific loan loss allocations was approximately \$579,000 at September 30, 2007 compared to approximately \$3,117,000 at December 31, 2006.

As of September 30, 2007 and December 31, 2006 approximately \$9,777,000 and \$7,102,000 of loans, respectively, not included in the nonaccrual table above or identified by management as being impaired were classified by management as having more than normal risk which raised doubts as to the ability of the borrower to comply with present loan repayment terms. The increase in loans having more than normal risk reflects the addition of several loans as a result of a regulatory examination completed in the third quarter. In addition to the classified list, our Company also maintains an internal watch list of loans, which for various reasons, not all related to credit quality, management is monitoring more closely than the average loan in the portfolio. Loans may be added to this list for reasons that are temporary and correctable, such as the absence of current financial statements of the borrower, or a deficiency in loan documentation. Other loans are added as soon as any problem is detected which might affect the borrower's ability to meet the terms of the loan. This could be initiated by the delinquency of a scheduled loan payment, a deterioration in the borrower's financial condition identified in a review of periodic financial statements, a decrease in the value of the collateral securing the loan, or a change in the economic environment within which the borrower operates. Once the loan is placed on our Company's watch list, its condition is monitored closely. Any further deterioration in the condition of the loan is evaluated to determine if the loan should be assigned to a higher risk category.

The allowance for loan losses is available to absorb probable loan losses regardless of the category of loan to be charged off. The allowance for loan losses consists of three components: asset-specific reserves, reserves based on expected loss estimates, and unallocated reserves. The asset-specific component applies to loans evaluated individually for impairment and is based on management's best estimate of discounted cash repayments and proceeds from liquidating collateral. The actual timing and amount of repayments and the ultimate realizable value of the collateral may differ from management's estimate.

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

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

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result from existing conditions), collateral values, specific industry conditions within portfolio segments, bank regulatory examination results, and findings of our internal loan review department.

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

At September 30, 2007, management allocated \$8,912,000 of the \$9,218,000 total allowance for loan losses to specific loans and loan categories and \$306,000 was unallocated. At December 31, 2006, management allocated \$8,012,000 of the \$9,015,000 total allowance for loan losses to specific loans and loan categories and \$1,003,000 was unallocated. Due to current economic conditions that may impact our borrowers' ability to service their loans, management believes the decrease in the unallocated portion of the allowance for loan losses is appropriate. Considering the size of several of our Company's lending relationships and the loan portfolio in total, management believes that the September 30, 2007 overall allowance for loan losses is adequate.

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

Financial Condition

Total assets increased \$42,903,000 or 3.8% to \$1,185,615,000 at September 30, 2007 compared to \$1,142,712,000 at December 31, 2006. Total liabilities increased \$37,951,000 or 3.7% to \$1,075,718,000 compared to \$1,037,767,000 at December 31, 2006. Stockholders' equity increased \$5,187,000 or 4.9% to \$110,132,000 compared to \$104,945,000 at December 31, 2006.

Loans increased \$70,577,000 to \$882,890,000 at September 30, 2007 compared to \$812,313,000 at December 31, 2006. Commercial loans increased \$2,024,000; real estate construction loans decreased \$16,653,000; real estate mortgage loans increased \$88,992,000; and consumer loans decreased \$3,784,000. The decrease in construction loans and the increase in real estate mortgage loans primarily reflect the reclassification of completed construction loans to permanent real estate mortgage loans. The decrease in consumer loans reflects the low rates that existed in the consumer auto market that was fueled by manufacturers' financing programs which generally tend to offer more favorable financing rates than our Company. Our Company chose to not aggressively pursue consumer auto loans during the periods presented and as such this portion of the loan portfolio declined.

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Investment in debt securities classified as available-for-sale decreased \$9,221,000 or 5.0% to \$174,345,000 at September 30, 2007 compared to \$183,566,000 at December 31, 2006. Investments classified as available-for-sale are carried at fair value. During 2007 the market valuation account increased \$1,040,000 from a negative \$1,021,000 at December 31, 2006 to a positive \$19,000 to reflect the fair value of available-for-sale investments at September 30, 2007 and the net after tax increase resulting from the change in the market valuation adjustment of \$680,000 increased the stockholders' equity component from a negative \$667,000 at December 31, 2006 to a positive \$12,000 at September 30, 2007.

Investment in equity securities increased \$86,000 or 1.4% to \$6,293,000 at September 30, 2007 compared to \$6,207,000 at December 31, 2006. The increase reflects net purchases of Federal Home Loan Bank stock resulting from additional Federal Home Loan Bank borrowings partially offset by Federal Home Loan Bank stock retained by the purchasers of the Osage Valley Bank and Bank 10s charters.

At December 31, 2006 the market valuation account for the available-for-sale investments of (\$1,021,000) decreased the amortized cost of those investments to their fair value on that date and the net after tax increase resulting from the market valuation adjustment of (\$668,000) was reflected as a separate component of stockholders' equity.

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

Cash and cash equivalents, which consist of cash due from banks and Federal funds sold, decreased \$25,344,000 or 47.8% to \$27,656,000 at September 30, 2007 compared to \$53,001,000 at December 31, 2006. Further discussion of this decrease may be found in the section of this report titled "Sources and Uses of Funds".

Premises and equipment increased \$5,541,000 or 16.0% to \$40,248,000 at September 30, 2007 compared to \$34,707,000 at December 31, 2006. The increase reflects purchases of premises and equipment of \$7,505,000 offset by depreciation expense of \$1,470,000. The increase in premises and equipment is the result of construction projects related to three new branches in Columbia, Missouri and Clinton, Missouri.

Total deposits increased \$26,095,000 or 2.9% to \$925,960,000 at September 30, 2007 compared to \$899,865,000 at December 31, 2006. This increase in deposits primarily reflects an increase in public funds and growth in our banks in the Kansas City and Columbia, Missouri markets.

Federal funds purchased and securities sold under agreements to repurchase decreased \$3,464,000 or 11.8% to \$25,997,000 at September 30, 2007 compared to \$29,460,000 at December 31, 2006.

Other borrowed money increased \$14,784,000 or 31.2% to \$62,152,000 at September 30, 2007 compared to \$47,368,000 at December 31, 2006. The increase reflects a net increase in Federal Home Loan Bank advances.

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The increase in stockholders' equity reflects net income of \$6,807,000 less dividends declared of \$2,628,000, a \$680,000 change in unrealized holding losses, net of taxes, on investment in debt and equity securities available-for-sale, \$34,000 amortization of net gain and prior service cost for defined benefit plan, and a \$195,000 increase, net of taxes, related to stock option compensation expense.

No material changes in our Company's liquidity or capital resources have occurred since December 31, 2006.

Liquidity

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

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

Our Company has a number of sources of funds to meet liquidity needs on a daily basis. The deposit base, consisting of consumer and commercial deposits and large dollar denomination (\$100,000 and over) certificates of deposit, is a source of funds.

Other sources of funds available to meet daily needs include the sales of securities under agreements to repurchase. In addition, our banks are members of the Federal Home Loan Bank of Des Moines (FHLB). As members of the FHLB, our banks have access to credit products of the FHLB. At September 30, 2007, the amounts of available credit from the FHLB totaled \$74,486,000. As of September 30, 2007, our banks had \$62,152,000 in outstanding borrowings with the FHLB. Our banks have federal funds purchased lines with correspondent banks totaling \$48,000,000. As of September 30, 2007, our banks had \$2,200,000 in federal funds purchased. Finally, our Company has a \$20,000,000 line of credit with a correspondent bank. This line of credit had no balance in use as of September 30, 2007.

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Sources and Uses of Funds

For the nine months ended September 30, 2007 and 2006, net cash provided by operating activities was \$11,282,000 and \$12,813,000, respectively. \$1,674,000 of the decrease in net cash provided by operating activities reflects a lower level of net income.

Net cash used in investing activities was \$69,779,000 in 2007 versus \$15,012,000 in 2006. The primary increase in cash used in investing activities reflects an increase in loans and purchases of premises and equipment for three new branch facilities partially offset by lower purchases of debt securities and lower proceeds received by calls and sales of debt securities.

Net cash provided by financing activities was \$33,152,000 in 2007 versus \$11,425,000 in 2006. Our Company experienced a \$12,157,000 decrease in demand deposits in 2007 compared to a \$3,229,000 increase during the same period in 2006. Our Company experienced a \$15,213,000 increase in interest bearing transactions accounts and time deposits in 2007 compared to a \$19,314,000 decrease during the same period in 2006. Our Company experienced a net increase in Federal Home Loan Bank borrowings of \$14,784,000 during the first nine month of 2006 compared \$1,569,000 decrease during the same time period 2007. In addition federal funds sold and securities sold under agreements to repurchase increased \$4,548,000 in 2006 compared to a \$3,464,000 decrease in 2007.

Impact of New Accounting Pronouncements

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS No. 156). SFAS No. 156 requires all separately recognized servicing assets and liabilities to be initially measured at fair value. In addition, entities are permitted to choose to either subsequently measure servicing rights at fair value and report changes in fair value in earnings, or amortize servicing rights in proportion to and over the estimated net servicing income or loss and assess the rights for impairment. Beginning with fiscal year in which an entity adopts SFAS No. 156, it may elect to subsequently measure a class of servicing assets and liabilities at fair value. Post adoption, an entity may make this election as of the beginning of any fiscal year. An entity that elects to subsequently measure a class of servicing assets and liabilities at fair value should apply that election to all new and existing recognized servicing assets and liabilities within that class. The effect of remeasuring an existing class of servicing assets and liabilities at fair value is to be reported as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. SFAS No. 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The statement also requires additional disclosures. Our Company has adopted SFAS No. 156 as of January 1, 2007 and elected to use the amortized cost method of accounting for financial assets. The adoption of SFAS No. 156 did not have a material impact on our Company's financial position or results of operations.

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In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation 48, *Accounting for Uncertainty in Income Taxes*, an Interpretation of FAS No. 109, *Accounting for Income Taxes* (FIN 48). The Interpretation defines the threshold for recognizing the financial impact of uncertain tax provisions in accordance with FAS 109. An enterprise would be required to recognize, in its financial statements, the best estimate of the impact of a tax position only if that position is more-likely-than-not of being sustained on audit based solely on the technical merits of the position on the reporting date. In evaluating whether the probable recognition threshold has been met, the Interpretation would require the presumption that the tax position will be evaluated during an audit by taxing authorities. The term more-likely-than-not is defined as a likelihood of more than 50 percent. Individual tax positions that fail to meet the recognition threshold will generally result in either (a) a reduction in the deferred tax asset or an increase in a deferred tax liability or (b) an increase in a liability for income taxes payable or the reduction of an income tax refund receivable. The impact may also include both (a) and (b). This Interpretation also provides guidance on disclosure, accrual of interest and penalties, accounting in interim periods, and transition. The Interpretation is effective for reporting periods after December 15, 2006. Our Company adopted the provisions of FIN 48 on January 1, 2007, and the adoption had no material impact on our Company's financial position or results of operations. See Income Taxes in the notes to the financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. The changes to current practice resulting from the application of this statement relates to the definition of fair value, the methods used to estimate fair value, and the requirements for expanded disclosures about estimates of fair value. SFAS No. 157 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Our Company is currently evaluating the impact of the adoption of SFAS No. 157; however, it is not expected to have a material impact on our Company's financial position or results of operations.

In September 2006, the Emerging Issues Task Force Issue 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements, was ratified. This EITF Issue addresses accounting for separate agreements which split life insurance policy benefits between an employer and employee. The Issue requires the employer to recognize a liability for future benefits payable to the employee under these agreements. The effects of applying this Issue must be recognized through either a change in accounting principle through an adjustment to equity or through the retrospective application to all prior periods. For calendar year companies such as our Company, the Issue is effective beginning January 1, 2008. Our Company does not expect the adoption of the Issue to have a material effect on our Company's consolidated financial statements.

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In February 2007, the FASB issued FAS No. 159, The Fair Value for Financial Assets and Financial Liabilities-Including an amendment to FAS No. 115. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with FASB's long-term measurement objectives for accounting for financial instruments. This Statement is effective for financial statements issued for the fiscal years beginning after November 15, 2007. Early adoption is permitted as of the beginning of the fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FAS No. 157, Fair Value Measurements. Company is currently evaluating the impact of the adoption of SFAS No. 159; however, it is not expected to have a material impact on our Company's financial position or results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our Company's exposure to market risk is reviewed on a regular basis by our Banks' Asset/Liability Committees and Boards of Directors. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income. Management realizes certain risks are inherent and that the goal is to identify and minimize those risks. Tools used by our Banks' management include the standard GAP report subject to different rate shock scenarios. At September 30, 2007, the rate shock scenario models indicated that annual net interest income could decrease or increase by as much as 11.7% should interest rates rise or fall, respectively, within 200 basis points from their current level over a one year period compared to 9.4% at December 31, 2006. However there are no assurances that the change will not be more or less than this estimate. Management further believes this is an acceptable level of risk.

Item 4. Controls and Procedures

Our Company's management has evaluated, with the participation of our principal executive and principal financial officers, the effectiveness of our disclosure controls and procedures as of September 30, 2007. Based upon and as of the date of that evaluation, our principal executive and principal financial officers concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported as and when required. It should be noted that any system of disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any system of disclosure controls and procedures is based in part upon assumptions about the likelihood of future events. Because of these and other inherent limitations of any such system, there can be no assurance that any design will always succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

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There has been no change in our Company's internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. However, as a result of the mergers of our banks, we have consolidated various subsidiary controls in order to eliminate duplication of various controls.

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PART II OTHER INFORMATION

| | |
|---|------|
| Item 1. Legal Proceedings | None |
| Item 1A. Risk Factors | None |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | None |
| Item 3. Defaults Upon Senior Securities | None |
| Item 4. Submission of Matters to a Vote of Security Holders | None |
| Item 5. Other Information | None |

Item 6. Exhibits

| Exhibit No. | Description |
|-------------|---|
| 3.1 | Articles of Incorporation of our Company (filed as Exhibit 3(a) to our Company's Registration Statement on Form S-4 (Registration No. 33-54166) and incorporated herein by reference). |
| 3.2 | Bylaws of our Company (filed as Exhibit 3.2 to our Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2002 (Commission file number 0-23636) and incorporated herein by reference). |
| 4 | Specimen certificate representing shares of our Company's \$1.00 par value common stock (filed as Exhibit 4 to our Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1999 (Commission file number 0-23636) and incorporated herein by reference). |
| 31.1 | Certificate of the Chief Executive Officer of our Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certificate of the Chief Financial Officer of our Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certificate of the Chief Executive Officer of our Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certificate of the Chief Financial Officer of our Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HAWTHORN BANCSHARES, INC.

Date

/s/ James E. Smith

November 9, 2007

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

/s/ Richard G. Rose

November 9, 2007

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

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HAWTHORN BANCSHARES, INC.

INDEX TO EXHIBITS

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| Exhibit No. | Description | Page No. |
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** Incorporated by reference.