
HWBK 10-K 12/31/2007

Section 1: 10-K (FORM 10-K)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 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
incorporation or organization)

43-1626350

(I.R.S. Employer Identification No.)

300 Southwest Longview Boulevard, Lee's Summit, Missouri
(Address of principal executive offices)

64081
(Zip Code)

(816) 347-8100

(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of Each Class	Name of Each Exchange on Which Registered
None	N/A

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

Common Stock, par value \$1.00 per share
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

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

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

The aggregate market value of the 3,435,033 shares of voting and non-voting common equity of the registrant held by non-affiliates computed by reference to the \$32.50 closing price of such common equity on June 29, 2007, the last business day of the registrant's most recently completed

second fiscal quarter, was \$111,638,573. Aggregate market value excludes an aggregate of 736,230 shares of common stock held by officers and directors and by each person known by the registrant to own 5% or more of the outstanding common stock on such date. Exclusion of shares held any by of these persons should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant, or that such person is controlled by or under common control with the registrant. As of March 3, 2008, the registrant had 4,298,353 shares of common stock, par value \$1.00 per share, issued and 4,169,495 shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated by reference into the indicated parts of this report: (1) 2007 Annual Report to Shareholders — Part II and (2) definitive Proxy Statement for the 2008 Annual Meeting of Shareholders to be filed with the Commission pursuant to Regulation 14A — Part III.

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PART I

Item 1. Business.

This report and the documents incorporated by reference herein contain forward-looking statements, which are inherently subject to risks and uncertainties. See “Forward Looking Statements” under Item 7 of this report.

General

Our Company, Hawthorn Bancshares, Inc., is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. Hawthorn was incorporated under the laws of the State of Missouri on October 23, 1992 as Exchange National Bancshares, Inc. and changed its name to Hawthorn Bancshares, Inc. in June 2007. Hawthorn owns all of the issued and outstanding capital stock of Union State Bancshares, Inc., which in turn owns all of the issued and outstanding capital stock of Hawthorn Bank. Hawthorn and Union State Bancshares each received approval from the Federal Reserve and elected to become a financial holding company on October 21, 2001.

Hawthorn acquired Hawthorn Bank and its constituent predecessor banks, as well as Union State Bancshares, in a series of transactions that are summarized as follows:

- On April 7, 1993 our Company acquired all of the issued and outstanding capital stock of The Exchange National Bank of Jefferson City, a national banking association, pursuant to a corporate reorganization involving an exchange of shares;
- On November 3, 1997, our Company acquired Union State Bancshares, Inc., and Union’s wholly-owned subsidiary, Union State Bank and Trust of Clinton;
- Following the May 4, 2000 acquisition of Citizens State Bank of Calhoun by Union State Bank, Citizens State Bank merged into Union State Bank to form Citizens Union State Bank & Trust;
- On January 3, 2000, our Company acquired Osage Valley Bank;
- On June 16, 2000, Hawthorn acquired City National Savings Bank, FSB, which was then merged into Exchange National Bank; and
- On May 2, 2005, our Company acquired all of the issued and outstanding capital stock of Bank 10, a Missouri state bank.

On December 1, 2006, our Company announced its development of a strategic plan in which, among other things, Exchange National Bank, Citizens Union State Bank, Osage Valley Bank and Bank 10 would be consolidated into a single bank under a Missouri state trust charter. This consolidation was completed in October 2007, and our subsidiary bank is now known as Hawthorn Bank.

Except as otherwise provided herein, references herein to “Hawthorn” or our “Company” include Hawthorn and its consolidated subsidiaries, and references herein to our “Bank” refers to Hawthorn Bank and its constituent predecessors.

Description of Business

Hawthorn. Hawthorn is a bank holding company registered under the Bank Holding Company Act that has elected to become a financial holding company. Our Company’s activities currently are limited to ownership, indirectly through its subsidiary (Union State Bancshares, Inc.), of the outstanding capital stock of Hawthorn Bank. In addition to ownership of its subsidiaries, Hawthorn may seek expansion through acquisition and may engage in those activities (such as investments in banks or operations that are financial in nature) in which it is permitted to engage under applicable law. It is not currently anticipated that Hawthorn

will engage in any business other than that directly related to its ownership of its banking subsidiary or other financial institutions.

Union. Union State Bancshares, Inc. is a bank holding company registered under the Bank Holding Company Act that has elected to become a financial holding company. Union's activities currently are limited to ownership of the outstanding capital stock of Hawthorn Bank. It is not currently anticipated that Union will engage in any business other than that directly related to its ownership of Hawthorn Bank.

Hawthorn Bank. Hawthorn Bank was founded in 1932 as a Missouri bank and converted to a Missouri trust company on August 16, 1989. However, its predecessors trace their lineage back to the founding of Exchange National Bank in 1865. Hawthorn Bank has 25 banking offices, including its principal office at 132 East High Street in Jefferson City's central business district. See "Item 2. Properties".

Hawthorn Bank is a full service bank conducting a general banking and trust business, offering its customers checking and savings accounts, internet banking, debit cards, certificates of deposit, trust services, brokerage services, safety deposit boxes and a wide range of lending services, including commercial and industrial loans, single payment personal loans, installment loans and commercial and residential real estate loans.

Hawthorn Bank's deposit accounts are insured by the Federal Deposit Insurance Corporation (the "FDIC") to the extent provided by law. Hawthorn Bank's operations are supervised and regulated by the FDIC and the Missouri Division of Finance. Periodic examinations of Hawthorn Bank are conducted by representatives of the FDIC and the Missouri Division of Finance. Such regulations, supervision and examinations are principally for the benefit of depositors, rather than for the benefit of the holders of Hawthorn Bank's common stock. See "Regulation Applicable to Bank Holding Companies" and "Regulation Applicable to our Bank".

Employees

As of December 31, 2007, Hawthorn and its subsidiaries had approximately 319 full-time and 59 part-time employees. None of its employees is presently represented by any union or collective bargaining group, and our Company considers its employee relations to be satisfactory.

Competition

Bank holding companies and their subsidiaries and affiliates encounter intense competition from nonbanking as well as banking sources in all of their activities. Our Bank's competitors include other commercial banks, thrifts, savings banks, credit unions and money market mutual funds. Thrifts and credit unions now have the authority to offer checking accounts and to make corporate and agricultural loans and were granted expanded investment authority by recent federal regulations. In addition, large national and multinational corporations have in recent years become increasingly visible in offering a broad range of financial services to all types of commercial and consumer customers. In our Bank's service areas, new competitors, as well as the expanding operations of existing competitors, have had, and are expected to continue to have, an adverse impact on our Bank's market share of deposits and loans in such service areas.

Our Bank experiences substantial competition for deposits and loans within both its primary service areas of Jefferson City, Clinton, Lee's Summit, Warsaw, Springfield, and Branson, Missouri and its secondary service area of the nearby communities in Cole, Henry, Cass, Benton and Greene counties of Missouri. Hawthorn Bank's principal competition for deposits and loans comes from other banks within its primary service areas and, to an increasing extent, other banks in nearby communities. Based on publicly available information, management believes that Hawthorn Bank is the fourth largest (in terms of deposits) of the thirteen banks within Cole county, the largest (in terms of deposits) of the nine banks within Henry county, the fourth largest (in terms of deposits) of the nineteen banks within Cass county, and the largest (in

terms of deposits) of the five banks within Benton county. The main competition for Hawthorn Bank's trust services is from other commercial banks, including those of the Kansas City metropolitan area.

Regulation Applicable to Bank Holding Companies

General. As a registered bank holding company and a financial holding company under the Bank Holding Company Act (the "BHC Act") and the Gramm-Leach-Bliley Act (the "GLB Act"), Hawthorn is subject to supervision and examination by the Board of Governors of the Federal Reserve System (the "FRB"). The FRB has authority to issue cease and desist orders against bank holding companies if it determines that their actions represent unsafe and unsound practices or violations of law. In addition, the FRB is empowered to impose civil money penalties for violations of banking statutes and regulations. Regulation by the FRB is intended to protect depositors of our Bank, not the shareholders of Hawthorn.

Limitation on Acquisitions. The BHC Act requires a bank holding company to obtain prior approval of the FRB before:

- taking any action that causes a bank to become a controlled subsidiary of the bank holding company;
- acquiring direct or indirect ownership or control of voting shares of any bank or bank holding company, if the acquisition results in the acquiring bank holding company having control of more than 5% of the outstanding shares of any class of voting securities of such bank or bank holding company, and such bank or bank holding company is not majority-owned by the acquiring bank holding company prior to the acquisition;
- acquiring substantially all of the assets of a bank; or
- merging or consolidating with another bank holding company.

Limitation on Activities. The activities of bank holding companies are generally limited to the business of banking, managing or controlling banks, and other activities that the FRB has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In addition, under the GLB Act, a bank holding company, all of whose controlled depository institutions are "well capitalized" and "well managed" (as defined in federal banking regulations) with "satisfactory" Community Reinvestment Act ratings, may declare itself to be a "financial holding company" and engage in a broader range of activities. As noted above, Hawthorn is registered as a financial holding company.

A financial holding company may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or incidental or complementary to activities that are financial in nature. "Financial in nature" activities include:

- securities underwriting, dealing and market making;
- sponsoring mutual funds and investment companies;
- insurance underwriting and insurance agency activities;
- merchant banking; and
- activities that the FRB determines to be financial in nature or incidental to a financial activity or which is complementary to a financial activity and does not pose a safety and soundness risk.

A financial holding company that desires to engage in activities that are financial in nature or incidental to a financial activity but not previously authorized by the FRB must obtain approval from the FRB before engaging in such activity. Also, a financial holding company may seek FRB approval to engage in an activity that is complementary to a financial activity, if it shows, among other things, that the activity does not pose a substantial risk to the safety and soundness of its insured depository institutions or the financial system.

A financial holding company generally may acquire a company (other than a bank holding company, bank or savings association) engaged in activities that are financial in nature or incidental to activities that are financial in nature without prior approval from the FRB. Prior FRB approval is required, however, before the financial holding company may acquire control of more than 5% of the voting shares or substantially all of the assets of a bank holding company, bank or savings association. In addition, under the FRB's merchant banking regulations, a financial holding company is authorized to invest in companies that engage in activities that are not financial in nature, as long as the financial holding company makes its investment with the intention of limiting the duration of the investment, does not manage the company on a day-to-day basis, and the company does not cross-market its products or services with any of the financial holding company's controlled depository institutions.

If any subsidiary bank of a financial holding company ceases to be "well-capitalized" or "well-managed" and fails to correct its condition within the time period that the FRB specifies, the FRB has authority to order the financial holding company to divest its subsidiary banks. Alternatively, the financial holding company may elect to limit its activities and the activities of its subsidiaries to those permissible for a bank holding company that is not a financial holding company. If any subsidiary bank of a financial holding company receives a rating under the Community Reinvestment Act (the "CRA") of less than "satisfactory", then the financial holding company is prohibited from engaging in new activities or acquiring companies other than bank holding companies, banks or savings associations until the rating is raised to "satisfactory" or better.

Regulatory Capital Requirements. The FRB has issued risk-based and leverage capital guidelines applicable to United States banking organizations. If a bank holding company's capital falls below minimum required levels, then the bank holding company must implement a plan to increase its capital, and its ability to pay dividends and make acquisitions of new bank subsidiaries may be restricted or prohibited. The FRB's risk-based guidelines define a two-tier capital framework. Tier 1 capital includes common shareholders' equity, trust preferred securities, minority interests and qualifying preferred stock, less goodwill and other adjustments. Tier 2 capital consists of preferred stock not qualifying as Tier 1 capital, mandatory convertible debt, limited amounts of subordinated debt, other qualifying term debt and the allowance for credit losses up to 1.25% of risk-weighted assets and other adjustments. The sum of Tier 1 and Tier 2 capital less investments in unconsolidated subsidiaries represents our total capital.

The risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets (including certain off-balance sheet activities). The FRB's capital adequacy guidelines require that bank holding companies maintain a Tier 1 risk-based capital ratio equal to 4% of its risk-weighted assets and a total risk-based capital ratio equal to 8% of its risk-weighted assets. In addition, the FRB has established a minimum leverage ratio for bank holding companies. The FRB's capital adequacy guidelines require that bank holding companies meeting specified criteria (including having the highest regulatory rating) maintain a Tier 1 leverage ratio equal to 3% of its average total consolidated assets. All other bank holding companies generally will be required to maintain a leverage ratio of at least 4%.

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On December 31, 2007, Hawthorn was in compliance with all of the FRB's capital adequacy guidelines. Hawthorn's capital ratios on December 31, 2007 are shown below:

Leverage Ratio (3% minimum requirement)	Tier 1 Risk-Based Capital Ratio (4% minimum requirement)	Total Risk-Based Capital Ratio (8% minimum requirement)
9.12 %	11.08%	13.24%

Interstate Banking and Branching. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Riegle-Neal Act"), a bank holding company is permitted to acquire the stock or substantially all of the assets of banks located in any state regardless of whether such transaction is prohibited under the laws of any state. The FRB will not approve an interstate acquisition if, as a result of the acquisition, the bank holding company would control more than 10% of the total amount of insured deposits in the United States or would control more than 30% of the insured deposits in the home state of the acquired bank. The 30% of insured deposits state limit does not apply if the acquisition is the initial entry into a state by a bank holding company or if the home state waives such limit. The Riegle-Neal Act also authorizes banks to merge across state lines, thereby creating interstate branches. Banks are also permitted to acquire and to establish de novo branches in other states where authorized under the laws of those states.

Under the Riegle-Neal Act, individual states may restrict interstate acquisitions in two ways. A state may prohibit an out-of-state bank holding company from acquiring a bank located in the state unless the target bank has been in existence for a specified minimum period of time (not to exceed five years). A state may also establish limits on the total amount of insured deposits within the state which are controlled by a single bank holding company, provided that such deposit limit does not discriminate against out-of-state bank holding companies.

Source of Strength. FRB policy requires a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. Under this "source of strength doctrine," a bank holding company is expected to stand ready to use its available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and to maintain resources and the capacity to raise capital which it can commit to its subsidiary banks. Furthermore, the FRB has the right to order a bank holding company to terminate any activity that the FRB believes is a serious risk to the financial safety, soundness or stability of any subsidiary bank.

Liability of Commonly Controlled Institutions. Under cross-guaranty provisions of the Federal Deposit Insurance Act (the "FDIA"), bank subsidiaries of a bank holding company are liable for any loss incurred by the Deposit Insurance Fund (the "DIF"), the federal deposit insurance fund for banks, in connection with the failure of any other bank subsidiary of the bank holding company.

Missouri Bank Holding Company Regulation. Missouri prohibits any bank holding company from acquiring ownership or control of any bank or Missouri depository trust company that has Missouri deposits if, after such acquisition, the bank holding company would hold or control more than 13% of total Missouri deposits. Because of this restriction, among others, a bank holding company, prior to acquiring control of a bank or depository trust company that has deposits in Missouri, must receive the approval of the Missouri Division of Finance.

Regulation Applicable to our Bank

General. Hawthorn Bank, a Missouri state non-member depository trust company, is subject to the regulation of the Missouri Division of Finance and the FDIC. The FDIC is empowered to issue cease and desist orders against our Bank if it determines that any activities of our Bank represent unsafe and unsound banking practices or violations of law. In addition, the FDIC has the power to impose civil money penalties

for violations of banking statutes and regulations. Regulation by these agencies is designed to protect the depositors of the Bank; not shareholders of Hawthorn.

Bank Regulatory Capital Requirements. The FDIC has adopted minimum capital requirements applicable to state non-member banks, which are similar to the capital adequacy guidelines established by the FRB for bank holding companies. Federal banking laws require the federal regulatory agencies to take prompt corrective action against undercapitalized financial institutions. A bank is identified as being “well-capitalized” if it has a total Tier 1 leverage ratio of 5% or greater, a Tier 1 risk-based capital ratio of 6% or greater and a total risk-based capital ratio of 10% or greater (and is not subject to any order or written directive specifying any higher capital ratio).

On December 31, 2007, our Bank was classified as “well-capitalized,” which is required for it to remain a financial holding company. The capital ratios and classifications of our Bank as of December 31, 2007 are shown on the following chart.

Leverage Ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio
9.33 %	11.36%	12.35%

Limitations on Interest Rates and Loans to One Borrower. The rate of interest a bank may charge on certain classes of loans is limited by state and federal law. At certain times in the past, these limitations have resulted in reductions of net interest margins on certain classes of loans. Federal and state laws impose additional restrictions on the lending activities of banks. The maximum amount that a Missouri state-chartered bank may lend to any one person or entity is generally limited to 15% of the unimpaired capital of the bank located in a city having a population of 100,000 or more, 20% of the unimpaired capital of the bank located in a city having a population of less than 100,000 and over 7,000, and 25% of the unimpaired capital of the bank if located elsewhere in the state.

Payment of Dividends. Our Bank is subject to federal and state laws limiting the payment of dividends. Under the FDIA, an FDIC-insured institution may not pay dividends while it is undercapitalized or if payment would cause it to become undercapitalized. The National Bank Act and Missouri banking law also prohibit the declaration of a dividend out of the capital and surplus of the bank. These laws and regulations are not expected to have a material effect upon the current dividend policies of our Bank.

Community Reinvestment Act. Our Bank is subject to the CRA and implementing regulations. CRA regulations establish the framework and criteria by which the bank regulatory agencies assess an institution’s record of helping to meet the credit needs of its community, including low- and moderate-income neighborhoods. CRA ratings are taken into account by regulators in reviewing certain applications made by Hawthorn and its banking subsidiary.

Limitations on Transactions with Affiliates. Hawthorn and its non-bank subsidiaries are “affiliates” within the meaning of the Federal Reserve Act. The amount of loans or extensions of credit which our Bank may make to non-bank affiliates, or to third parties secured by securities or obligations of the non-bank affiliates, are substantially limited by the Federal Reserve Act and the FDIA. Such acts further restrict the range of permissible transactions between a bank and an affiliated company. A bank and its subsidiaries may engage in certain transactions, including loans and purchases of assets, with an affiliated company only if the terms and conditions of the transaction, including credit standards, are substantially the same as, or at least as favorable to the bank as, those prevailing at the time for comparable transactions with non-affiliated companies or, in the absence of comparable transactions, on terms and conditions that would be offered to non-affiliated companies.

Other Banking Activities. The investments and activities of our Bank are also subject to regulation by federal banking agencies regarding investments in subsidiaries, investments for their own account (including limitations on investments in junk bonds and equity securities), loans to officers, directors and their affiliates, security requirements, anti-tying limitations, anti-money laundering, financial privacy and customer identity verification requirements, truth-in-lending, the types of interest bearing deposit accounts which it can offer, trust department operations, brokered deposits, audit requirements, issuance of securities, branching and mergers and acquisitions.

Changes in Laws and Monetary Policies

Recent Legislation. On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide the enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. The proposed changes are intended to allow shareholders to monitor the performance of companies and directors more easily and efficiently.

The Sarbanes-Oxley Act generally applies to all companies that file or are required to file periodic reports with the Securities and Exchange Commission, or “SEC”, under the Securities and Exchange Act of 1934. Further, the Sarbanes-Oxley Act includes very specified additional disclosure requirements and new corporate governance rules, requires the SEC, securities exchanges and the Nasdaq Global Market to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of certain issues by the SEC and the Comptroller General. Given the extensive SEC role in implementing rules relating to many of the Sarbanes-Oxley Act’s new requirements, the final scope of these requirements remains to be determined.

The Sarbanes-Oxley Act addresses, among other matters: audit committees; certification of financial statements by the chief executive officer and the chief financial officer; the forfeiture of bonuses and profits made by directors and senior officers in the twelve month period covered by restated financial statements; a prohibition on insider trading during pension plan black out periods; disclosure of off-balance sheet transactions; a prohibition on personal loans to directors and officers (excluding federally insured financial institutions); expedited filing requirements for stock transaction reports by officers and directors; the formation of a public accounting oversight board; auditor independence; and various increased criminal penalties for violations of securities laws. Management has taken various measures to comply with the requirements of the Sarbanes-Oxley Act.

Future Legislation. Various pieces of legislation, including proposals to change substantially the financial institution regulatory system, are from time to time introduced and considered by the Missouri state legislature and the United States Congress. This legislation may change banking statutes and the operating environment of Hawthorn in substantial and unpredictable ways. If enacted, this legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions and other financial institutions. Hawthorn cannot predict whether any of this potential legislation will be enacted and, if enacted, the effect that it, or any implementing regulations, could have on Hawthorn’s business, results of operations or financial condition.

Fiscal Monetary Policies. Hawthorn’s business and earnings are affected significantly by the fiscal and monetary policies of the federal government and its agencies. Hawthorn is particularly affected by the policies of the FRB, which regulates the supply of money and credit in the United States. Among the instruments of monetary policy available to the FRB are:

- conducting open market operations in United States government securities;
- changing the discount rates of borrowings of depository institutions;

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- imposing or changing reserve requirements against depository institutions' deposits; and
- imposing or changing reserve requirements against certain borrowings by bank and their affiliates.

These methods are used in varying degrees and combinations to directly affect the availability of bank loans and deposits, as well as the interest rates charged on loans and paid on deposits. The policies of the FRB have a material effect on Hawthorn's business, results of operations and financial condition.

The references in the foregoing discussion to various aspects of statutes and regulation are merely summaries, which do not purport to be complete and which are qualified in their entirety by reference to the actual statutes and regulations.

Available Information

The address of our principal executive offices is 300 Southwest Longview Boulevard, Lee's Summit, Missouri 64081 and our telephone number at this location is (816) 347-8100. Our common stock trades on the Nasdaq Global Market under the symbol "HWBK".

We electronically file certain documents with the SEC. We file annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K (as appropriate), along with any related amendments and supplements. From time-to-time, we also may file registration and related statements pertaining to equity or debt offerings. You may read and download our SEC filings over the internet from several commercial document retrieval services as well as at the SEC's internet website (www.sec.gov). You may also read and copy our SEC filings at the SEC's public reference room located at 100 F Street, NE., Washington, DC 20549. Please call the SEC 1-800-SEC-0330 for further information concerning the public reference room and any applicable copy charges.

Our internet website address is www.hawthornbancshares.com. Under the "Documents" section of our website (www.hawthornbancshares.com), we make available our public filings with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, or any amendments to those reports filed or furnished to the SEC pursuant to Section 13(a) of the Securities Exchange Act of 1934. Our Company will provide a copy of any of our public filings, excluding exhibits, free of charge upon written request made to Kathleen L. Bruegenhemke, Hawthorn Bancshares, Inc., 132 East High Street, Jefferson City, MO 65101. Please note that any internet addresses provided in this report are for information purposes only and are not intended to be hyperlinks. Accordingly, no information found and/or provided at such internet addresses is intended or deemed to be incorporated by reference herein.

Item 1A. Risk Factors.

Risk Factors

We are identifying important risks and uncertainties that could affect our Company's results of operations, financial condition or business and that could cause them to differ materially from our Company's historical results of operations, financial condition or business, or those contemplated by forward-looking statements made herein or elsewhere, by, or on behalf of, our Company. Factors that could cause or contribute to such differences include, but are not limited to, those factors described below. The risk factors highlighted below are not the only ones that our Company faces.

Because We Primarily Serve Missouri, A Decline In The Local Economic Conditions Could Lower Hawthorn's Profitability. The profitability of Hawthorn is dependant on the profitability of its banking subsidiary, which operates out of central and west central Missouri. The financial condition of this bank is affected by fluctuations in the economic conditions prevailing in the portion of Missouri in which its

operations are located. Accordingly, the financial conditions of both Hawthorn and its banking subsidiary would be adversely affected by deterioration in the general economic and real estate climate in Missouri.

An increase in unemployment, a decrease in profitability of regional businesses or real estate values or an increase in interest rates are among the factors that could weaken the local economy. With a weaker local economy:

- customers may not want or need the products and services of Hawthorn's banking subsidiary,
- borrowers may be unable to repay their loans,
- the value of the collateral security of our Bank's loans to borrowers may decline, and
- the overall quality of our Bank's loan portfolio may decline.

Making mortgage loans and consumer loans is a significant source of profits for Hawthorn's banking subsidiary. If individual customers in the local area do not want these loans, profits may decrease. Although our Bank could make other investments, our Bank may earn less revenue on these investments than on loans. Also, our Bank's losses on loans may increase if borrowers are unable to make payments on their loans.

Interest Rate Changes May Reduce Our Profitability And Our Banking Subsidiary. The primary source of earnings for Hawthorn's banking subsidiary is net interest income. To be profitable, our Bank has to earn more money in interest and fees on loans and other interest-earning assets than it pays as interest on deposits and other interest-bearing liabilities and as other expenses. If prevailing interest rates decrease, as has already happened on several occasions since January 2001, including in 2008, the amount of interest our Bank earn on loans and investment securities may decrease more rapidly than the amount of interest our Bank has to pay on deposits and other interest-bearing liabilities. This would result in a decrease in the profitability of Hawthorn and its banking subsidiary, other factors remaining equal.

Changes in the level or structure of interest rates also affect

- our Bank's ability to originate loans,
- the value of our Bank's loan and securities portfolios,
- our Bank's ability to realize gains from the sale of loans and securities,
- the average life of our Bank's deposits, and
- our Bank's ability to obtain deposits.

Fluctuations in interest rates will ultimately affect both the level of income and expense recorded on a large portion of our Bank's assets and liabilities, and the market value of all interest-earning assets, other than interest-earning assets that mature in the short term. Our Bank's interest rate management strategy is designed to stabilize net interest income and preserve capital over a broad range of interest rate movements by matching the interest rate sensitivity of assets and liabilities. Although Hawthorn believes that its Bank's current mix of loans, mortgage-backed securities, investment securities and deposits is reasonable, significant fluctuations in interest rates may have a negative effect on the profitability of our Bank.

Our Profitability Depends On Their Asset Quality And Lending Risks. Success in the banking industry largely depends on the quality of loans and other assets. The loan officers of Hawthorn's banking subsidiary are actively encouraged to identify deteriorating loans. Loans are also monitored and categorized through an analysis of their payment status. For example, recent reviews by our credit officer identified areas of concern that resulted in heightened attention being given to reducing concentrations of credit and, in particular, to strengthening credit quality and administration. Our Bank's failure to timely and accurately monitor the quality of its loans and other assets could have a materially adverse effect on the operations and financial condition of Hawthorn and its banking subsidiary. There is a degree of credit risk associated with any lending activity. Our Bank attempts to minimize its credit risk through loan diversification. Although

our Bank's loan portfolio is varied, with no undue concentration in any one industry, substantially all of the loans in the portfolio have been made to borrowers in central, west central, and southwest Missouri. Therefore, the loan portfolio is susceptible to factors affecting the central, west central, and southwest Missouri area and the level of non-performing assets is heavily dependant upon local conditions. There can be no assurance that the level of our Bank's non-performing assets will not increase above current levels. High levels of non-performing assets could have a materially adverse effect on the operations and financial condition of Hawthorn and its banking subsidiary.

Our Provision For Probable Loan Losses May Need To Be Increased. Hawthorn's banking subsidiary makes a provision for loan losses based upon management's analysis of probable losses in the loan portfolio and consideration of prevailing economic conditions. Our Bank may need to increase the provision for loan losses through additional provisions in the future if the financial condition of any of its borrowers deteriorates or if real estate values decline. Furthermore, various regulatory agencies, as an integral part of their examination process, periodically review the loan portfolio, provision for loan losses, and real estate acquired by foreclosure of our Bank. Such agencies may require our Bank to recognize additions to the provision for loan losses based on their judgments of information available to them at the time of the examination. Any additional provision for probable loan losses, whether required as a result of regulatory review or initiated by Hawthorn itself, may materially alter the financial outlook of Hawthorn and its banking subsidiary.

If We Are Unable To Successfully Compete For Customers In Our Market Area, Our Financial Condition And Results Of Operations Could Be Adversely Affected. Hawthorn's banking subsidiary faces substantial competition in making loans, attracting deposits and providing other financial products and services. Our Bank has numerous competitors for customers in its market area.

Such competition for loans comes principally from:

- other commercial banks
- savings banks
- savings and loan associations
- mortgage banking companies
- finance companies
- credit unions

Competition for deposits comes principally from:

- other commercial banks
- savings banks
- savings and loan associations
- credit unions
- brokerage firms
- insurance companies
- money market mutual funds
- mutual funds (such as corporate and government securities funds)

Many of these competitors have greater financial resources and name recognition, more locations, more advanced technology and more financial products to offer than our Bank. Competition from larger institutions may increase due to an acceleration of bank mergers and consolidations in Missouri and the rest of the nation. In addition, the Gramm-Leach-Bliley Act removes many of the remaining restrictions in federal banking law against cross-ownership between banks and other financial institutions, such as insurance companies and securities firms. The law will likely increase the number and financial strength of companies that compete directly with our Bank. The profitability of our Bank depends of its continued ability to attract new customers and compete in Missouri. New competitors, as well as the expanding operations of existing competitors, have had, and are expected to continue to have, an adverse impact on our Bank's market share of deposits and loans in our Bank's service areas. If our Bank is unable to successfully compete, its financial condition and results of operations will be adversely affected.

We May Experience Difficulties In Managing Our Growth And In Effectively Integrating Newly Acquired Companies. As part of our general strategy, Hawthorn may continue to acquire banks and businesses that it believes provide a strategic fit with its business. 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. Acquiring other banks and businesses will involve risks commonly associated with acquisitions, including:

- potential exposure to liabilities of the banks and businesses acquired;
- difficulty and expense of integrating the operations and personnel of the banks and businesses acquired;
- difficulty and expense of instituting the necessary systems and procedures, including accounting and financial reporting systems, to manage the combined enterprises on a profitable basis;
- potential disruption to our existing business and operations;
- potential diversion of the time and attention of our management; and
- impairment of relationships with and the possible loss of key employees and customers of the banks and businesses acquired.

The success of our internal growth strategy will depend primarily on the ability of our banking subsidiary to generate an increasing level of loans and deposits at acceptable risk levels and on acceptable terms without significant increases in non-interest expenses relative to revenues generated. There is no assurance that we will be successful in implementing our internal growth strategy.

We May Be Adversely Affected By Changes In Laws And Regulations Affecting The Financial Services Industry. Banks and bank holding companies such as Hawthorn are subject to regulation by both federal and state bank regulatory agencies. The regulations, which are designed to protect borrowers and promote certain social policies, include limitations on the operations of banks and bank holding companies, such as minimum capital requirements and restrictions on dividend payments. The regulatory authorities have extensive discretion in connection with their supervision and enforcement activities and their examination policies, including the imposition of restrictions on the operation of a bank, the classification of assets by an institution and requiring an increase in a bank's allowance for loan losses. These regulations are not necessarily designed to maximize the profitability of banking institutions. Future changes in the banking laws and regulations could have a material adverse effect on the operations and financial condition of Hawthorn and its banking subsidiary.

Our Success Largely Depends On The Efforts Of Our Executive Officers. The success of Hawthorn and its banking subsidiary has been largely dependant on the efforts of James Smith, Chairman and CEO and David Turner, President and the other executive officers. These individuals are expected to continue to perform their services. However, the loss of the services of Messrs. Smith or Turner, or any of the other key executive officers could have a materially adverse effect on Hawthorn and its subsidiary bank.

We Cannot Predict How Changes In Technology Will Affect Our Business. The financial services market, including banking services, is increasingly affected by advances in technology, including developments in:

- telecommunications
- data processing
- automation
- Internet-based banking
- telebanking
- debit cards and so-called "smart cards"

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Our ability to compete successfully in the future will depend on whether they can anticipate and respond to technological changes. To develop these and other new technologies our Bank will likely have to make additional capital investments. Although our Bank continually invests in new technology, there can be no assurance that our Bank will have sufficient resources or access to the necessary proprietary technology to remain competitive in the future.

Additional Factors. Additional risks and uncertainties that may affect the future results of operations, financial condition or business of our Company and its banking subsidiary include, but are not limited to: (i) adverse publicity, news coverage by the media, or negative reports by brokerage firms, industry and financial analysts regarding our Bank or our Company; and (ii) changes in accounting policies and practices.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

Neither Hawthorn Bancshares nor Union State Bancshares owns or leases any property.

On February 14, 2007, our principal offices were relocated from Jefferson City, Missouri to Hawthorn Bank's branch located at 300 Southwest Longview Boulevard, Lee's Summit, Missouri. The Lee's Summit location will serve as our principal offices temporarily until permanent facilities are located in the Kansas City metropolitan area.

The table below provides a list of our Bank's facilities.

Location	Approximate Square Footage	Owned or Leased	Net Book Value at December 31, 2007 (in thousands)
8127 East 171 st Street Belton, Missouri	13,000	Owned	\$3,373
4675 Gretna Road Branson, Missouri	11,000	Owned	\$2,184
1000 West Buchanan Street California, Missouri	2,270	Owned	\$ 800
102 North Second Street Clinton, Missouri	11,524	Owned	\$2,371
115 North Main Street Clinton, Missouri	1,500	Owned	\$ 579
1603 East Ohio Clinton, Missouri	5,760	Owned	\$ 816
1400 East Ohio Street Clinton, Missouri	13,551	Owned	\$4,140
1712 East Ohio Street Clinton, Missouri (inside a Wal-Mart store)	600	Leased (1)	N/A
1101 North Highway 13 Collins, Missouri	1,500	Owned	\$ 46

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Location	Approximate Square Footage	Owned or Leased	Net Book Value at December 31, 2007 (in thousands)
1110 Club Village Drive Columbia, Missouri	5,000	Owned	\$2,818
115 South 2 nd Street Drexel, Missouri	4,000	Owned	\$ 316
100 Plaza Drive Harrisonville, Missouri	4,000	Owned	\$ 707
17430 East 39 th Street Independence, Missouri	4,070	Owned	\$1,689
220 West White Oak Independence, Missouri	1,800	Owned	\$ 179
132 East High Street Jefferson City, Missouri	34,800	Owned	\$4,754
3701 West Truman Boulevard Jefferson City, Missouri	21,000	Owned	\$ 359
211 West Dunklin Street Jefferson City, Missouri	2,400	Owned	\$ 736
800 Eastland Drive Jefferson City, Missouri	4,100	Owned	\$ 989
7321 South Lindbergh St. Louis, MO	1,302	Leased (2)	N/A
300 S.W. Longview Boulevard Lee's Summit, Missouri	11,700	Owned	\$3,589
335 Chestnut Osceola, Missouri	1,580	Owned	\$ 85
500 North Mott Drive, #103C Raymore, Missouri (in the Foxwood Springs Seniors Center)	462	Leased (3)	N/A
595 VFW Memorial Drive St. Robert, Missouri	2,236	Owned	\$ 115
321 West Battlefield Springfield, Missouri	12,500(4)	Owned	\$1,600
445 South Moreau Tipton, Missouri	1,962	Owned	\$ 111
200 West Main Street Warsaw, Missouri	8,900	Owned	\$ 645
1891 Commercial Drive Warsaw, Missouri	11,000	Owned	\$2,534
125 South Main Windsor, Missouri	3,600	Owned	\$ 427

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- (1) The initial five-year term of the lease expired in January 2004, at which time our Bank exercised the first of two five-year renewal options granted to it for the lease of this facility.
 - (2) The term of this lease is three years beginning March 7, 2006.
 - (3) The term of this lease can be terminated at any time upon thirty days notice.
 - (4) Of the 12,500 square feet of space, 6,600 square feet of space is leased to a non-affiliate.

Management believes that the condition of each of our Bank's facilities presently is adequate for its business and that such facilities are adequately covered by insurance.

Item 3. Legal Proceedings.

None of Hawthorn or its subsidiaries is involved in any material pending legal proceedings, other than routine litigation incidental to their business.

Item 4. Submission of Matters to a Vote of Security Holders.

No matter was submitted to a vote of the holders of our Company's common stock during the fourth quarter of the year ended December 31, 2007.

EXECUTIVE OFFICERS OF THE REGISTRANT

Executive officers of our Company are appointed by the board of directors and serve at the discretion of the board. The following table sets forth certain information with respect to all executive officers of our Company.

Name	Age	Position
James E. Smith	63	Chairman, Chief Executive Officer and Director
David T. Turner	51	President and Director
Richard G. Rose	56	Chief Financial Officer
Kathleen L. Bruegenhemke	42	Senior Vice President and Secretary
James H. Taylor, Jr.	58	Senior Vice President and Senior Credit Officer

The business experience of the executive officers of our Company during the last five years is as follows:

James E. Smith has served as a director of Hawthorn Bank (or of its constituent predecessors) since 1975 and of our Company since 1997. He served as vice chairman of our Company from 1998 through March 2002 when he assumed the responsibilities of chairman and chief executive officer, as president and secretary of Hawthorn Bank from 1975 through May 2000 when he was promoted to chairman and chief executive officer, as president of a predecessor to Hawthorn Bank from January 2000 through October 2002, and as vice chairman of another predecessor to Hawthorn Bank from October 2002 through March 2007.

David T. Turner has served as a director of Hawthorn Bank (or of its constituent predecessors) and of our Company since January 1997. Mr. Turner served as vice chairman of our Company from June 1998 through March 2002 when he assumed the position of president. From 1993 until June 1998, he served as senior vice president of our Company. Mr. Turner served as president of a predecessor to Hawthorn Bank from January 1997 through March 2002 when he assumed the position of chairman, chief executive officer and president. He served as senior vice president of that same predecessor from June 1992 through December 1996 and as its vice president from 1985 until June 1992.

Richard G. Rose has served as Chief Financial Officer of our Company since June 2007 and Senior Vice President and Chief Financial Officer of Hawthorn Bank (or of one of its constituent predecessors) since June 2007. Mr. Rose served as Treasurer of our Company from July 1998 through June 2007 and Senior Vice President and Controller of our Bank from July 1998 through June 2007. Prior to joining Hawthorn Bank, he served as Senior Vice President and Controller of the First National Bank of St. Louis from June 1979 until June 1998.

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Kathleen L. Bruegenhemke has served as Senior Vice President and Secretary of our Company since November 1997. From January 1992 until November 1997, she served as Internal Auditor of Hawthorn Bank (or of one of its constituent predecessors). Prior to joining our Bank, Ms. Bruegenhemke served as a Commissioned Bank Examiner for the Federal Deposit Insurance Corporation.

James H. Taylor, Jr. has served as Senior Vice President and Senior Credit Officer of our Company since June 2005. Prior to joining our Company, Mr. Taylor served as an executive officer in various senior management capacities with Deutsche Financial Services Corp., a wholly owned subsidiary of Deutsche Bank, A.G., Frankfurt, Germany.

There is no arrangement or understanding between any executive officer and any other person pursuant to which such executive officer was selected as an officer.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Pursuant to General Instruction G(2) to Form 10-K, the information required by this Item, other than that referred to below, is incorporated herein by reference to the information under the caption "Market Price of and Dividends on Equity Securities and Related Matters" in our Company's 2007 Annual Report to Shareholders.

We refer you to Item 12 of this report under the caption "Securities Authorized For Issuance Under Equity Compensation Plans" for certain equity plan information.

Our Purchases of Equity Securities

The following table summarizes the purchases made by or on behalf of our Company or certain affiliated purchasers of shares of our common stock during the fourth quarter of the year ended December 31, 2007:

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs *
October 1-31, 2007	—	—	—	\$1,280,783
November 1-30, 2007	5,000	\$29.06	5,000	\$1,135,483
December 1-31, 2007	—	—	—	\$1,135,483
Total	5,000	\$29.06	5,000	\$1,135,483

* On August 22, 2001, our Company announced that our Board of Directors authorized the purchase, through open market transactions, of up to \$2,000,000 market value of our Company's common stock. Management was given discretion to determine the number and pricing of the shares to be purchased, as well as, the timing of any such purchases. On November 26, 2002, our Company announced that our board of directors authorized an additional \$2,000,000 for the purchase of our Company's stock through open market transactions.

Item 6. Selected Financial Data.

Pursuant to General Instruction G(2) to Form 10-K, the information required by this Item is incorporated herein by reference to information under the caption “Selected Consolidated Financial Data” in our Company’s 2007 Annual Report to Shareholders.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation.

Pursuant to General Instruction G(2) to Form 10-K, the information required by this Item is incorporated herein by reference to the information under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our Company’s 2007 Annual Report to Shareholders.

Forward-Looking Statements

This report, including information included or incorporated by reference in this report, contains certain forward-looking statements with respect to the financial condition, results of operations, plans, objectives, strategy, future performance and business of our Company and its subsidiaries, including, without limitation:

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

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

- competitive pressures among financial services companies may increase significantly,
- costs or difficulties related to the integration of the business of Hawthorn and its acquisition targets may be greater than expected,
- changes in the interest rate environment may reduce interest margins,
- general economic conditions, either nationally or in Missouri, may be less favorable than expected,
- legislative or regulatory changes may adversely affect the business in which Hawthorn and its subsidiaries are engaged,
- technological changes may be more difficult or expensive than anticipated, and
- changes may occur in the securities markets.

We have described additional factors that could cause actual results to be materially different from those described in the forward-looking statements, which factors are identified in Item 1A of this report under the heading “Risk Factors.” Other factors that we have not identified in this report could also have this effect. You are cautioned not to put undue reliance on any forward-looking statement, which speak only as of the date such statement is made. Except as otherwise required by law, we undertake no obligation to publicly update or revise any forward-looking statement to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Pursuant to General Instruction G(2) to Form 10-K, the information required by this Item is incorporated herein by reference to:

- (i) the information under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Interest Sensitivity” in our Company’s 2007 Annual Report to Shareholders; and
- (ii) the information under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Risk Management” in our Company’s 2007 Annual Report to Shareholders.

Item 8. Financial Statements and Supplementary Data.

Pursuant to General Instruction G(2) to Form 10-K, the information required by this Item is incorporated herein by reference to the report of the independent auditors and the information under the caption “Consolidated Financial Statements” in our Company’s 2007 Annual Report to Shareholders.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

Evaluation of Disclosure 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 December 31, 2007. Based upon and as of the date of that evaluation, our principal executive officer and principal financial officer 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.

Internal Controls Over Financial Reporting.

Management’s Report on Internal Control Over Financial Reporting.

Our Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Securities Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control — Integrated Framework*, our Company’s management concluded that our internal control over financial reporting was effective as of December 31, 2007. Our management’s assessment of the effectiveness of our internal control

over financial reporting as of December 31, 2007 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Changes in Internal Controls.

There has been no change in our Company's internal control over financial reporting that occurred during the fiscal quarter ended December 31, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Report of Independent Registered Public Accounting Firm.

The Board of Directors and Stockholders
Hawthorn Bancshares, Inc.:

We have audited Hawthorn Bancshares, Inc.'s (the Company) internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Hawthorn Bancshares, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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In our opinion, Hawthorn Bancshares, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Hawthorn Bancshares, Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2007, and our report dated March 14, 2008 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

St. Louis, Missouri
March 14, 2008

Item 9B. Other Information.

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

Pursuant to General Instruction G(3) to Form 10-K, the information required by this Item, other than that referred to below, is incorporated herein by reference to:

- (i) the information under the caption "Item 1: Election of Directors—What is the structure of our board and how often are directors elected?" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A;
- (ii) the information under the caption "Item 1: Election of Directors—Who are this year's nominees?" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A;
- (iii) the information under the caption "Item 1: Election of Directors—What is the business experience of the nominees and of our continuing board members?" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A;
- (iv) the information under the caption "Executive Officers of the Registrant" in Part I of this report;
- (v) the information under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A;
- (vi) the information under the caption "Corporate Governance and Board Matters—Consideration of Director Nominees" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A; and

- (vii) the information under the caption “Corporate Governance and Board Matters—Committees of the Board—Audit Committee” in our Company’s definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A.

Code of Ethics

Our Company has adopted a Code of Business Conduct and Ethics for directors, officers and employees including, our principal executive officer, principal financial officer, principal accounting officer, controller and persons performing similar functions. This Code of Business Conduct and Ethics is posted on our internet website (www.hawthornbancshares.com) under “Governance Documents” and is available for your examination. A copy of this Code will be furnished without charge upon written request to Kathleen L. Bruegenhemke, Secretary, Hawthorn Bancshares, Inc., 132 East High Street, Jefferson City, Missouri 65101. Any substantive amendment to, or waiver from, a provision of this Code that applies to our principal executive officer, principal financial officer, principal accounting officer, controller, or persons performing similar functions will be disclosed in a report on Form 8-K.

Item 11. Executive Compensation.

Pursuant to General Instruction G(3) to Form 10-K, the information required by this Item is incorporated herein by reference to:

- (i) the information under the caption “Executive Compensation and Related Matters” in our Company’s definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A;
- (ii) the information under the caption “Corporate Governance and Board Matters—Director Compensation” in our Company’s definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A; and
- (iii) the information under the caption “Corporate Governance and Board Matters—Compensation Committee Interlocks and Insider Participation” in our Company’s definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Pursuant to General Instruction G(3) to Form 10-K, the information required by this Item, other than that presented below, is incorporated herein by reference to the information under the caption “Ownership of Common Stock” in our Company’s definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A.

Securities Authorized For Issuance Under Equity Compensation Plans

Our Company has two equity compensation plans for its employees pursuant to which options, rights or warrants may be granted. The following is a summary of the shares reserved for issuance pursuant to outstanding options, rights or warrants granted under equity compensation plans as of December 31, 2007:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	242,968*	\$ 27.23	593,845**
Equity compensation plans not approved by security holders	-0-	-0-	-0-
Total	242,968*	\$ 27.23	593,845**

* Consists of shares reserved for issuance pursuant to outstanding stock option grants under our Company's incentive stock option plan.

** Consists of 193,845 shares available for future issuance under our Company's incentive stock option plan and 400,000 shares available for future issuance under our Company's 2007 omnibus incentive plan.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

Pursuant to General Instruction G(3) to Form 10-K, the information required by this Item is incorporated herein by reference to:

- (i) the information under the caption "Related Party Transactions" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A;
- (ii) the information under the caption "Item 1: Election of Directors—What is the structure of our board and how often are directors elected?" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A; and
- (iii) the information under the caption "Corporate Governance and Board Matters—Committees of the Board" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A.

Item 14. Principal Accountant Fees and Services.

Pursuant to General Instruction G(3) to Form 10-K, the information required by this Item is incorporated herein by reference to the information under the caption "Independent Auditor Fees and Services" in our Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A.

PART IV

Item 15. Exhibits, Financial Statements Schedules.

(a) Exhibits, Financial Statements and Financial Statement Schedules:

1. Financial Statements:

The following consolidated financial statements of our Company and reports of our Company's independent registered public accounting firm, included in our Annual Report to Shareholders for the year ended December 31, 2007 under the caption "Consolidated Financial Statements", are incorporated herein by reference:

Report of Independent Registered Public Accounting Firm.

Consolidated Balance Sheets as of December 31, 2007 and 2006.

Consolidated Statements of Income for the years ended December 31, 2007, 2006 and 2005.

Consolidated Statements of Stockholders' Equity and Comprehensive Income for the years ended December 31, 2007, 2006 and 2005.

Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005.

Notes to Consolidated Financial Statements.

2. Financial Statement Schedules:

Financial statement schedules have been omitted because they either are not required or are not applicable or because equivalent information has been included in the financial statements, the notes thereto or elsewhere herein.

3. Exhibits:

<u>Exhibit No.</u>	<u>Description</u>
3.1	Restated Articles of Incorporation of our Company (filed as Exhibit 3.1 to our Company's current report on Form 8-K on August 9, 2007 and incorporated herein by reference).
3.2	Amended and Restated Bylaws of our Company (filed as Exhibit 3.2 to our Company's current report on Form 8-K on November 1, 2007 and incorporated herein by reference).
4	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 year ended December 31, 1999 and incorporated herein by reference).
10.1	Employment Agreement, dated November 3, 1997, between our Company and James E. Smith (filed as Exhibit 10.4 to our Company's Annual Report on Form 10-K for the year ended December 31, 1997 and incorporated herein by reference).*
10.2	Exchange National Bancshares, Inc. Incentive Stock Option Plan (filed as Exhibit 10.2 to our Company's Annual Report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference).*

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Exhibit No.	Description
10.3	Form of Change of Control Agreement and schedule of parties thereto (filed as Exhibit 10.2 to our Company's Quarterly Report on Form 10-Q for the quarterly period March 31, 2005 and incorporated herein by reference).*
10.4	Relocation Agreement, dated June 20, 2007, between our Company and James H. Taylor, Jr. and Laura A. Taylor, individually and as trustees of the Taylor, Jr. Trust dated October 18, 1998 (filed as Exhibit 10.1 to our Company's current report on Form 8-K on June 22, 2007 and incorporated herein by reference).*
10.5	Employment Agreement, dated May 31, 2005, between our Company and James H. Taylor, Jr.*
13	Our Company's 2007 Annual Report to Shareholders (only those portions of this Annual Report to Shareholders which are specifically incorporated by reference into this Annual Report on Form 10-K shall be deemed to be filed with the Commission).
14	Code of Business Conduct and Ethics of our Company (filed as Exhibit 14 to our Company's Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).
21	List of Subsidiaries
23	Consent of Independent Registered Public Accounting Firm.
24	Power of Attorney (included on the signature page to this Annual Report on Form 10-K).
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Management contracts or compensatory plans or arrangements required to be identified by Item 15(a).

(b) Exhibits.

See exhibits identified above under Item 15(a)3.

(c) Financial Statement Schedules.

See financial statement schedules identified above under Item 15(a)2, if any.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: March 14, 2008

By /s/ James E. Smith
James E. Smith, Chairman of the Board
and Chief Executive Officer

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints James E. Smith and Richard G. Rose, or either of them, his attorneys-in-fact, for such person in any and all capacities, to sign any amendments to this report and to file the same, with exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that either of said attorneys-in-fact, or substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Date</u>	<u>Signature and Title</u>
March 14, 2008	<u>/s/ James E. Smith</u> James E. Smith, Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
March 14, 2008	<u>/s/ Richard G. Rose</u> Richard G. Rose, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)
March 14, 2008	<u>/s/ David T. Turner</u> David T. Turner, Director
March 14, 2008	<u>/s/ Charles G. Dudenhoeffer, Jr.</u> Charles G. Dudenhoeffer, Jr., Director
March 14, 2008	<u>/s/ Philip D. Freeman</u> Philip D. Freeman, Director
March 14, 2008	<u>/s/ Kevin L. Riley</u> Kevin L. Riley, Director
March 14, 2008	<u>/s/ Julius F. Wall,</u> Julius F. Wall, Director
March 14, 2008	<u>/s/ Gus S. Wetzel, II</u> Gus S. Wetzel, II, Director

EXHIBIT INDEX

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Section 2: EX-10.5 (EMPLOYMENT AGREEMENT - JAMES H. TAYLOR, JR.)

EMPLOYMENT AGREEMENT

THIS AGREEMENT (this "Agreement") is entered into this 31st day of May, 2005, between Exchange National Bancshares, Inc., a Missouri corporation (the "Company"), and James H. Taylor, Jr. (the "Employee"). Collectively, the Company, the Employee, and the Bank (as defined below) may be referred to as the "Parties" and each individually as a "Party."

WITNESSETH:

WHEREAS, the Company is a bank holding company controlling 100% of the issued and outstanding shares of common stock of Union State Bank & Trust of Clinton, a Missouri trust company (the "Bank"); and

WHEREAS, Employee desires to become employed by the Company in an executive capacity as Senior Vice President and Senior Credit Officer of the Company for a period of at least three (3) years, and the Company desires to employ Employee to serve in such capacity, for the compensation and in accordance with the terms and provisions contained in this Agreement; and

NOW, THEREFORE, in consideration of the foregoing and the mutual promises and covenants contained herein, the Company and Employee agree as follows:

1. Employment. The Company agrees to employ the Employee and the Employee agrees to be employed by the Company in an executive capacity upon the terms and conditions of this Agreement for a period of three (3) years from and after the date of this Agreement, and any extensions thereafter, unless earlier terminated as provided in Section 9 hereof. At each anniversary of the date of this Agreement, this Agreement shall be automatically extended for one additional year unless the Company or the Employee gives the other party written notice of such party's intention not to extend the Agreement at least thirty (30) days prior to such anniversary date. Employee agrees that he will accept employment as Senior Vice President and Senior Credit Officer of the Company, without limitation of other titles, for the effective period of this Agreement. The Employee's primary location of employment during the term of this Agreement shall be in Saint Louis, Missouri unless the Employee consents in writing to relocate to another geographic location.

2. Compensation. For all services rendered by the Employee to the Company, the Company shall pay the Employee a salary of not less than one hundred fifty thousand dollars (\$150,000) per year, payable in accordance with the customary payroll practices of the Company, but in no event less frequently than monthly. Salary payments shall be subject to withholding and other applicable taxes. Employee shall be eligible for merit-based increases in compensation on the terms and conditions offered to employees of the Company generally having responsibilities commensurate to that of Employee. Employee shall be eligible to participate in such bonus or other incentive compensation plans as currently are or may be established by the Company for employees generally having responsibilities commensurate to

that of Employee, provided that in any given fiscal year, the bonus compensation to the Employee shall not be less than 20% of Employee's base salary.

3. Expenses. The Company shall reimburse the Employee for all ordinary and necessary expenses incurred and paid by the Employee in the course of the performance of the Employee's duties pursuant to this Agreement and consistent with the Company's policies in effect from time to time with respect to travel, entertainment, other business expenses, and expenses relating to memberships in business organizations, including without limitation the Risk Management Association and the Certified Fraud Examiners Association. Reimbursement of such expenses shall be subject to the Company's requirements with respect to the manner of reporting such expenses.

4. Additional Benefits. The Employee shall be eligible for such fringe benefits, if any, by way of insurance, hospitalization, vacations, stock bonus plans, and profit sharing plans normally provided to employees of the Company generally having responsibility commensurate to that of the Employee and such additional benefits as may be from time to time agreed upon in writing between the Employee and the Company; and further provided, to that there shall be no waiting period for eligibility to participate in such additional benefits. The Company shall provide to the Employee a new Company owned or leased automobile of a year, make, and model agreed to between the Company and the Employee, befitting the executive office held by Employee not less than every three years, and the Company shall pay the expenses related to the use, upkeep, and insurance of the vehicle. At the termination of this Agreement, Employee shall have the option to purchase the vehicle for the contractual buy-out price of any loan or lease on the vehicle. If the vehicle is not financed or leased by the Company, Employee shall have the option to purchase the vehicle at a wholesale value to be agreed upon between the Company and Employee. The tax treatment of all fringe benefits shall be handled in a manner consistent with the customary practices of the Bank and the Company.

5. Duties. The Employee agrees that so long as he is employed under this Agreement he will (i) to the satisfaction of the Company devote his best efforts and his entire business time to further the interests of the Company, (ii) at all times be subject to the direction and control of the Board of Directors of the Company with respect to his activities on behalf of the Company, (iii) comply with all rules, orders and regulations of the Company, (iv) truthfully and accurately maintain and preserve such records and make all reports as the Company may require, and (v) fully account for all monies and other property of the Company of which he may from time to time have custody and deliver the same to the Company whenever and however directed to do so.

6. Covenant Not To Disclose Confidential Information. The Employee acknowledges that during the course of his employment with the Company he has or will have access to and knowledge of certain information and data which the Company considers confidential and that the release of such information or data to unauthorized persons would be extremely detrimental to the Company. As a consequence, the Employee hereby agrees and acknowledges that he owes a duty to the Company not to disclose, and agrees that, during or after the term of his employment, without the prior written consent of the Company he will not

communicate, publish or disclose, to any person anywhere or use any Confidential Information (as hereinafter defined) for any purpose other than carrying out his duties as contemplated by this Agreement. The Employee will use his best efforts at all times to hold in confidence and to safeguard any Confidential Information from falling into the hands of any unauthorized person and, in particular, will not permit any Confidential Information to be read, duplicated, or copied. The Employee will return to the Company all Confidential Information in the Employee's possession thereof, or whenever the Company shall so request, and in any event will promptly return all such Confidential Information if the Employee's relationship with the Company is terminated for any reason and will not retain any copies thereof. The term "Confidential Information" shall mean any information or data used by or belonging or relating to the Company that is not known generally to the banking community, including without limitation, any and all proprietary data and information relating to the Company's or the Bank's past, present or future business plans, services offered, financial information, customer lists, and other information concerning customers, depositors, and borrowers of the Company or any subsidiary of the Company, whether or not reduced to writing, or information or data which the Company advises the Employee should be treated as confidential information.

7. Covenant Not To Compete. The Employee agrees that during the term of his employment by the Company, and for a period of two (2) years from and after the termination of such employment for any reason other than a termination by the Employee pursuant to Section 9(c), he will not, directly or indirectly, without the express written consent of the Company:

- a. own, manage, operate, control, or participate in the ownership, management, operation, control, or financing of, or have any interest, financial or otherwise, in or act as an officer, director, partner, principal, employee, agent, representative, consultant, or independent contractor of, or in any way assist any bank, savings and loan, savings bank, or other financial institution (other than the Bank) that is located or has an office in Cole County, Missouri.
- b. solicit for employment or hire any employees of the Bank; or
- c. solicit, or interfere with, any contracts or business relationships with any customer, depositor, or borrower of the Bank.

8. Remedies. In the event that the Employee breaches any of the foregoing covenants and assurances contained in Section 6 or 7, the Company and its successors and assigns, in addition to such other remedies which may be available to them, shall be entitled to an injunction, including a mandatory injunction, to be issued by any court of competent jurisdiction ordering compliance with this Agreement or enjoining or restraining the Employee, and each and every person, firm, or company acting in concert or participation with him, from the continuation of such breach. Should a court of competent jurisdiction find that an actual breach occurred, the Employee shall pay to the Company all ascertainable damages, including costs and reasonable attorneys' fees sustained by the Company by reason of the breach of said covenant and assurances. The obligations of the Employee and the rights of the

Company, its successors and assigns under Sections 6 and 7 of this Agreement shall survive the termination of this Agreement. The covenant and the obligations of the Employee set forth in Sections 6 and 7 are in addition to and not in lieu of or exclusive of any other obligations and duties of the Employee to the Company, whether express or implied in fact or in law.

9. Termination Prior to Change in Control.

a. This Agreement shall terminate immediately upon the death, disability, or adjudication of legal incompetence of the Employee. Termination pursuant to this subparagraph (a) shall not affect any benefits Employee or Employee's successors may be entitled to under any life or disability policy provided to the Employee by the Company. For purposes of this Agreement, the Employee shall be deemed disabled when the Employee has become unable, by reason of physical or mental disability, to satisfactorily perform his essential job duties and there is no reasonable accommodation that can be provided to enable him to be a qualified individual with a disability under applicable law. Such matters shall be determined by, or to the reasonable satisfaction of, the Board of Directors of the Company.

b. This Agreement may be terminated by the Company upon notice to the Employee for "Cause." For purposes of this Agreement, "Cause" shall mean the occurrence of any of the following events:

- i. Performance by the Employee of illegal or fraudulent acts, criminal conduct or willful misconduct, or gross negligence relating to the activities of the Company or the Bank;
- ii. Performance by the Employee of any criminal acts involving moral turpitude having a material adverse effect upon the Company or the Bank, including, without limitation, upon their profitability, reputation, or goodwill;
- iii. Failure by the Employee to perform his duties in a manner which he knows, or has reason to know, to be in the Company's or the Bank's best interests, which he fails to cure within thirty days after receiving written notice thereof;
- iv. Continued conduct by the Employee that is damaging to the business, employee, or customer relations of the Company or the Bank and which is ongoing more than thirty days after receiving written notice from the Company or the Bank to cease such conduct; or
- v. Any other material breach of the Employee's obligations under this Agreement which is incurable or which he fails to cure within thirty days after receiving written notice thereof.

c. This Agreement may be terminated by the Employee upon written notice to the Company in the event of a material breach of the Company's obligations under this Agreement which is incurable or which the Company fails to cure within 15 days after receiving written notice thereof.

d. In the event this Agreement is terminated for Cause, the parties' obligations under this Agreement shall terminate immediately (except as otherwise provided herein), and neither the Employee nor his estate, heirs, successors, or assigns shall be entitled to any further compensation under the Agreement other than payment of any unpaid severance or compensation that accrued prior to such termination; provided, however, that the termination of this Agreement pursuant to subsections (b) or (c) of this Section shall not limit any other remedies to which the terminating party may be entitled to in law or equity as a result of any breach of this Agreement by the other Party.

e. In the event that the Employee's employment with the Company is terminated by the Company, other than for "Cause," or if the Employee shall voluntarily terminate his employment pursuant to subsection (c) of this section, then, in either case, the Company agrees to continue to pay to Employee his monthly salary as in effect at the time of termination for the remaining effective period under the Agreement, but in any scenario for no less than twelve (12) months, following the date of termination of employment, and during such period shall also continue to pay the Employee's insurance benefit costs up to the dollar amount paid by the Company during the year immediately prior to such termination; provided, however, in the event of a "Change of Control," as defined in that certain Agreement attached as Appendix A and incorporated herein (the "Change of Control Agreement"), the provisions of the Change of Control Agreement will apply. To the extent there are any inconsistent provisions in the Change of Control Agreement and the Employment Agreement, the Change of Control Agreement will control, invalidating any inconsistent or duplicative provision in the Employment Agreement.

f. Transfer of the Employee to a successor or permitted assign of the Company which shall offer employment to Employee on comparable terms as the Company shall not be considered termination of Employment for purposes of this Agreement. Any such offer of employment which requires relocation by Employee shall not be considered comparable. Further, any required change in geographic location, whether or not it follows a Change of Control, if not accepted by Employee, shall constitute a termination without "Cause," and further shall relieve Employee of his obligations under Section 7 and entitle Employee to the payment specified in Section 9(e). Should Employee agree to change in geographic location, the Company shall reimburse Employee for all costs associated with moving to the new geographic location, including without limitation the costs of moving Employee's personal belongings and other property.

10. Successors.

a. This Agreement is personal to the Employee and shall not be assigned by Employee without prior written consent of the Company otherwise than by will or the laws of descent and distribution.

b. This Agreement shall inure to the benefit of and be binding upon the Company and its successors and assigns.

c. The Company will require any successor (whether direct or indirect, by purchase, merger, consolidation, or otherwise) to all or substantially all of the business and/or assets of the Company to assume expressly and agree to perform this Agreement in the same manner and to the same extent that the Company would be required to perform it if no such succession had taken place.

11. Severability. The invalidity or unenforceability of any provision of this Agreement shall not affect the validity or enforceability of any other provision of this Agreement.

12. Waiver of Breach. Failure of the Company to demand strict compliance with any of the terms, covenants, or conditions of this Agreement shall not be deemed a waiver of the term, covenant, or condition, nor shall any waiver or relinquishment by the Company of any right or power hereunder at any one time or more times be deemed a waiver or relinquishment of the right or power at any other time or times.

13. No Conflicts. The Employee represents and warrants to the Company that neither the execution nor delivery of this Agreement, nor the performance of the Employee's obligations hereunder will conflict with, or result in a breach of, any term, condition, or provision of, or constitute a default under, any obligation, contract, agreement, covenant, or instrument to which the Employee is a party or under which the Employee is bound, including without limitation, the breach by the Employee of a fiduciary duty to any former employers.

14. Entire Agreement; Amendment. This Agreement cancels and supersedes all previous agreements relating to the subject matter of this Agreement, written or oral, between the parties hereto and contains the entire understanding of the parties relating to the terms of the Employee's employment and shall not be amended, modified, or supplemented in any manner whatsoever except as otherwise provided herein or in writing signed by each of the parties.

15. Headings. The headings of the sections of this Agreement have been inserted for convenience of reference only and shall in no way restrict or otherwise modify any of the terms or provisions hereof.

16. Governing Law. This Agreement and all rights and obligations of the Parties shall be governed by, and construed and interpreted in accordance with, the laws of the State

of Missouri applicable to agreements made and to be performed entirely within the State, including all matters of enforcement, validity, and performance.

17. Arbitration. Any dispute between any of the Parties or claim by a Party against another Party arising out of or in relation to this Agreement or in relation to any alleged breach thereof shall be finally determined by arbitration in accordance with the rules then in force of the American Arbitration Association, except as otherwise provided for in this Agreement. The arbitration proceedings shall take place in Saint Louis, Missouri, or such other location as the Parties in dispute may agree upon; and such proceedings shall be governed by the laws of the State of Missouri as such laws are applied to agreements between residents of such State entered into and to be performed entirely within that State.

The Parties shall agree upon one arbitrator, who shall be an individual skilled in the legal and business aspects of the subject matter of this Agreement and of the dispute. If the Parties cannot agree upon one arbitrator, each Party in dispute shall select one arbitrator and the arbitrators so selected shall select a third arbitrator. In the event the arbitrators cannot agree upon the selection of a third arbitrator, the third arbitrator shall be appointed by the American Arbitration Association at the request of the Parties in dispute. The arbitrator shall, if possible, be individuals skilled in the legal and business aspects of the subject of the Agreement and of the dispute.

The decision rendered by the arbitrator or arbitrators shall be accompanied by a written opinion in support thereof. The decision shall be final and binding upon the Parties without right to appeal. Judgment upon the decision may be entered into in any court having jurisdiction thereof, or application may be made to that court for a judicial acceptance of the decision and an order of enforcement. Costs of the arbitration shall be assessed by the arbitrator or arbitrators against any or all of the parties in dispute, and shall be paid promptly by the Party or Parties so assessed.

18. Counterparts. This Agreement may be executed in any number of counterparts, each of which shall be deemed to be an original and all of which together shall constitute one agreement which is binding upon all Parties.

19. Notice. All notices, requests, demands, and other communications shall be deemed duly given if delivered by hand or if mailed by certified or registered mail with postage prepaid or nationally recognized delivery service with delivery confirmed, addressed as follows:

If to the Company:

Exchange National Bancshares, Inc.
132 E. High Street
Jefferson City, MO 65010-0688
Attn: President

If to the Employee:

James H. Taylor, Jr.
6729 Wynfield Terrace Drive
St. Louis, MO 63129

or to any other address as either party may provide to the other in writing.

THIS AGREEMENT CONTAINS A BINDING ARBITRATION PROVISION WHICH MAY BE ENFORCED BY THE PARTIES.

IN WITNESS WHEREOF, the Company and Employee have executed this Agreement as of the day and year first above written.

COMPANY:

EXCHANGE NATIONAL BANCSHARES, INC.

By: /s/ James E. Smith

Name: James E. Smith

Title: Chairman & CEO

EMPLOYEE:

/s/ James H. Taylor, Jr.

James H. Taylor, Jr.

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Section 3: EX-13 (OUR COMPANY'S 2007 ANNUAL REPORT TO SHAREHOLDERS)

**2007
ANNUAL REPORT
TO
SHAREHOLDERS**

**HAWTHORN BANCSHARES, INC.
Lee's Summit, Missouri**



March 14, 2008

Dear Investors:

2007 was a challenging year for Hawthorn Bancshares, Inc. The Federal Reserve Board's actions tightened our spread between interest bearing assets and liabilities which resulted in net interest income decreasing \$1,637,000 or 4.1% compared to 2006. Additionally, Company resources were focused on internally re-organizing and re-branding our four separate banking subsidiaries into one bank and one operating platform. Nonrecurring expenses related to the consolidation, which was completed during the 4th quarter of 2007, totaled \$1,207,000. We knew that our investment in re-branding the entire organization would be sizable, but felt it was important to set a strong foundation for Hawthorn Bank under a single identity to make it easier for customers to do business with us and to distinguish Hawthorn Bank from the other banks in the region.

Capitalization, expressed in terms of tier one capital to adjusted average total assets (leverage ratio), was 9.12% at year-end 2007 compared to 8.77% at December 31, 2006. Total capital to risk-weighted assets was 13.24% at December 31, 2007 compared to 13.84% at year-end 2006. Both ratios continue to exceed the Federal Reserve's definition of "well capitalized". Shareholders received dividends totaling \$0.84 per share in 2007 which was consistent with dividends paid in 2006. At December 31, 2007, our Company's dividend yield was 3.36%. Management is proud of our Company's healthy dividend.

Regarding 2007 financial highlights, total assets increased to \$1,195,804,000. For 2007, return on average equity was 7.22% and the return on average assets was 0.67%, compared to 10.79% and 0.95% respectively for 2006.

Weakening Economy...Consumers Not Keeping Up...Price of Oil Hits another All Time High...Bearish Outlook...Sub-prime Lending Crisis... With headlines like these from major news sources, it is apparent that the financial industry is facing its greatest challenges in decades. Despite our challenging environment, Hawthorn Bancshares, Inc. is poised to weather these turbulent times. We increased the balance of our allowance for loan losses \$267,000 to \$9,282,000 at year-end 2007 (1.02% of outstanding loans). Net charge-offs for 2007 were \$887,000 compared to \$1,396,000 for 2006. While total non-performing loans did increase slightly from 0.62% of total loans at 2006 to 0.67% at year end 2007, this level is still considered manageable.

As we move forward in our strategic planning process, I assure you that Hawthorn Bancshares, Inc. will not lose sight of its long standing tradition of providing unrivaled customer service. Hawthorn Bancshares' philosophy of having local leadership in decision making roles will remain unchanged. The Directors and Management of our Company believe that Hawthorn Bancshares, Inc. has not reached its full financial potential. We are excited about things to come. Thank you for your continued support as we move forward with our strategic plan.

Sincerely,

A handwritten signature in dark ink, appearing to read "James E. Smith".

JAMES E. SMITH
Chairman & Chief Executive Officer

Hawthorn Bancshares | 300 S.W. Longview Blvd. | Lee's Summit, MO 6408-2101 | T 816.268.6318 | F 816.268.6318 | NASDAQ:HWBK



HAWTHORN BANCSHARES, INC.
DESCRIPTION OF BUSINESS

Our Company, Hawthorn Bancshares, Inc., is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. Hawthorn was incorporated under the laws of the State of Missouri on October 23, 1992 as Exchange National Bancshares, Inc. and changed its name to Hawthorn Bancshares, Inc. in August 2007. Hawthorn owns all of the issued and outstanding capital stock of Union State Bancshares, Inc., which in turn owns all of the issued and outstanding capital stock of Hawthorn Bank. Hawthorn and Union State Bancshares each received approval from the Federal Reserve and elected to become a financial holding company on October 17, 2001.

Hawthorn acquired Hawthorn Bank and its constituent predecessor banks, as well as Union State Bancshares, in a series of transactions that are summarized as follows:

- On April 7, 1993 our Company acquired all of the issued and outstanding capital stock of The Exchange National Bank of Jefferson City, a national banking association, pursuant to a corporate reorganization involving an exchange of shares;
- On November 3, 1997, our Company acquired Union State Bancshares, Inc., and Union's wholly-owned subsidiary, Union State Bank and Trust of Clinton;
- Following the May 4, 2000 acquisition of Citizens State Bank of Calhoun by Union State Bank, Citizens State Bank merged into Union State Bank to form Citizens Union State Bank & Trust;
- On January 3, 2000, our Company acquired Osage Valley Bank;
- On June 16, 2000, Hawthorn acquired City National Savings Bank, FSB, which was then merged into Exchange National Bank; and
- On May 2, 2005, our Company acquired all of the issued and outstanding capital stock of Bank 10, a Missouri state bank.

On December 1, 2006, our Company announced its development of a strategic plan in which, among other things, Exchange National Bank, Citizens Union State Bank, Osage Valley Bank and Bank 10 would be consolidated into a single bank under a Missouri state trust charter. This consolidation was completed in October 2007, and our subsidiary bank is now known as Hawthorn Bank.

Except as otherwise provided herein, references herein to "Hawthorn" or our "Company" include Hawthorn and its consolidated subsidiaries, and references herein to our "Bank" refers to Hawthorn Bank and its constituent predecessors.

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

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

SELECTED CONSOLIDATED FINANCIAL DATA

The following table presents selected consolidated financial information for our Company as of and for each of the years in the five-year period ended December 31, 2007. The selected consolidated financial data should be read in conjunction with the Consolidated Financial Statements of our Company, including the related notes, presented elsewhere herein.

(Dollars expressed in thousands, except share and per share data)

	Year Ended December 31,				
	2007	2006	2005	2004	2003
Income Statement Data					
Interest income	\$ 74,207	71,423	57,340	41,091	38,922
Interest expense	37,175	32,766	23,673	13,387	12,798
Net interest income	37,032	38,657	33,667	27,704	26,124
Provision for loan losses	1,154	1,326	1,322	942	1,092
Net interest income after provision for loan losses	35,878	37,331	32,345	26,762	25,032
Security gains (losses), net	(2)	(18)	(25)	(8)	38
Other noninterest income	10,223	8,618	7,290	5,741	6,666
Total noninterest income	10,221	8,600	7,265	5,733	6,704
Noninterest expense	35,054	30,148	25,368	20,383	18,536
Income before income taxes	11,045	15,783	14,242	12,112	13,200
Income taxes	3,245	4,908	4,327	3,807	4,156
Net income	\$ 7,800	10,875	9,915	8,305	9,044
Dividends					
Declared on common stock	\$ 3,504	3,503	3,503	3,378	3,183
Paid on common stock	3,504	3,503	3,378	3,378	2,988
Ratio of total dividends declared to net income	44.92%	32.21	35.33	40.67	35.19
Per Share Data					
Basic earnings per common share	\$ 1.87	2.61	2.38	1.99	2.17
Diluted earnings per common share	1.85	2.59	2.36	1.98	2.15
Basic weighted average shares of common stock outstanding	4,171,163	4,169,847	4,169,847	4,169,847	4,169,432
Diluted weighted average shares of common stock outstanding	4,210,844	4,204,547	4,198,859	4,204,752	4,209,272

Balance Sheet Data (at period end)	Year Ended December 31,				
	2007	2006	2005	2004	2003
Investment securities	\$ 157,368	189,773	179,692	171,718	188,956
Loans	911,278	812,312	813,535	636,637	583,919
Total assets	1,195,804	1,142,712	1,126,470	923,874	875,596
Total deposits	921,257	899,865	881,455	726,649	665,262
Securities sold under agreements to repurchase and other short term borrowed funds	25,730	31,196	38,094	35,413	73,672
Subordinated notes	49,486	49,486	49,486	25,774	—
Other borrowed money	77,915	47,368	52,180	39,525	41,630
Total stockholders' equity	111,199	104,945	96,733	91,771	87,783

Earnings Ratios

Return on average total assets	0.67%	0.95	0.91	0.93	1.09
Return on average stockholders' equity	7.22	10.79	10.47	9.16	10.45

Asset Quality Ratios

Allowance for loan losses to loans	1.02	1.11	1.12	1.18	1.42
Nonperforming loans to loans (1)	0.67	0.62	1.11	0.96	0.52
Allowance for loan losses to nonperforming loans (1)	152.54	177.95	100.39	123.05	274.29
Nonperforming assets to loans and foreclosed assets (2)	0.92	0.96	1.30	0.97	0.54
Net loan charge-offs to average loans	0.10	0.17	0.15	0.29	0.03

Capital Ratios

Average stockholders' equity to average total assets	9.34%	8.80	8.73	10.11	10.39
Total risk-based capital ratio	13.24	13.84	12.70	14.58	10.98
Tier 1 risk-based capital ratio	11.08	11.28	9.83	13.47	9.78
Leverage ratio	9.12	8.77	7.88	10.39	7.18

(1) Nonperforming loans consist of nonaccrual loans and loans contractually past due 90 days or more and still accruing interest.

(2) Nonperforming assets consist of nonperforming loans and foreclosed assets.

A WORD CONCERNING FORWARD-LOOKING STATEMENTS

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

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

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

- competitive pressures among financial services companies may increase significantly,
- costs or difficulties related to the integration of the business of Hawthorn and its acquisition targets may be greater than expected,
- changes in the interest rate environment may reduce interest margins,
- general economic conditions, either nationally or in Missouri, may be less favorable than expected,
- legislative or regulatory changes may adversely affect the business in which Hawthorn and its subsidiaries are engaged, and
- changes may occur in the securities markets.

We have described under the caption “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2007, and in other reports that we file with the SEC from time to time, additional factors that could cause actual results to be materially different from those described in the forward-looking statements. Other factors that we have not identified in this report could also have this effect. You are cautioned not to put undue reliance on any forward-looking statement, which speak only as of the date they were made.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

This overview of management's discussion and analysis highlights selected information in this document 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 document. These have an impact on our Company's financial condition and results of operation.

Material Challenges and Risks: Our Company may experience difficulties in managing growth and in 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.

Revenue Source: Through its branch network, our Bank provides products and services in four 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 surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee's Summit, Missouri. The products and services are offered to customers primarily within their respective geographical areas. The business segment results which follow 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 refinancings.

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

Our Company has prepared all of the consolidated financial information in this report in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). In preparing the consolidated financial statements in accordance with U.S. GAAP, 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.

EXECUTIVE SUMMARY

Our Company's consolidated net income decreased \$3,075,000 or 28.3% to \$7,800,000 for 2007 compared to \$10,875,000 for 2006 and followed a \$960,000 or 9.7% increase for 2006 compared to 2005. Basic earnings per common share increased from \$2.38 for 2005 to \$2.61 for 2006 and decreased to \$1.87 for 2007. Diluted earnings per common share increased from \$2.36 for 2005 to \$2.59 for 2006 and decreased to \$1.85 for 2007. Return on average total assets increased from 0.91% for 2005 to 0.95% for 2006 and decreased to 0.67% for 2007. Return on average total stockholders' equity increased from 10.47% for 2005 to 10.79% for 2006 and decreased to 7.22% for 2007.

Average loans outstanding increased \$24,065,000 or 2.9% to \$848,771,000 for 2007 compared to \$824,706,000 for 2006 and followed a \$81,324,000 or 10.9% increase for 2006 compared to 2005.

Average commercial loans outstanding decreased approximately \$1,184,000 or 0.79% for 2007 compared to 2006 and followed a \$1,829,000 or 1.3% decrease for 2006 compared to 2005. Average real estate loans outstanding increased approximately \$27,633,000 or 4.33% for 2007 compared to 2006 and followed a \$25,785,000 or 5.4% increase for 2006 compared to 2005. Average consumer loans outstanding decreased approximately \$2,384,000 or 6.7% for 2007 compared to 2006 and followed a \$2,906,000 or 8.1% decrease for 2006 compared to 2005.

While much of the banking industry experienced a down turn in real estate lending due to problems in the sub-prime real estate market, our Company experienced an increase in our real estate lending operations. Our Company's real estate loan growth is primarily in the area of commercial real estate lending. Our Company does not make sub-prime residential real estate loans. It should be noted that consumer loans decreased on average in 2007 and 2006. These decreases reflect the low rates that exist in the consumer auto market that is fueled by manufacturers' low or zero rate financing programs. Our Company chose to not aggressively pursue consumer auto loans during the periods presented and as such this portion of the loan portfolio declined in balance.

Average investment securities and federal funds sold decreased \$16,082,000 or 7.9% to \$188,375,000 for 2007 compared to \$204,457,000 for 2006 and followed a \$36,489,000 or 15.1% decrease for 2006 compared to 2005. The decrease in average investment securities during 2007 and 2006 reflects the use of investment liquidity to fund our Company's growth in the loan portfolio.

Average deposits increased \$17,024,000 or 1.9% to \$903,881,000 for 2007 compared to \$886,857,000 for 2006 and followed a \$44,502,000 or 5.3% increase for 2006 compared to 2005. These increases are a result of our expanded branch network.

Average federal funds purchased and securities sold under agreements to repurchase decreased \$11,289,000 or 26.7% to \$31,061,000 for 2007 compared to \$42,350,000 for 2006 and followed a \$3,915,000 or 8.5% decrease for 2006 compared to 2005.

Average interest-bearing demand notes to U.S. Treasury decreased \$499,000 or 70.1% to \$205,000 for 2007 compared to \$704,000 for 2006 and followed a \$8,000 or 1.1% increase for 2006 compared to 2005. Balances in this account are governed by the U.S. Treasury's funding requirements. The decrease in 2007 is due to our Company changing from a Treasury Tax and Loan Note Option Depositary to a Treasury Tax and Loan Remittance bank.

Average subordinated notes was \$49,486,000 in 2007 and 2006 and followed a \$3,872,000 or 10.9% increase for 2006 compared to 2005. Our Company issued \$23,712,000 of subordinated notes in March 2005. In 2005 the proceeds were used to provide part of the funding for the acquisition of Bank 10.

Average other borrowed money decreased \$3,131,000 or 5.5% to \$53,626,000 for 2007 compared to \$56,757,000 for 2006 and followed a \$8,327,000 or 17.2% increase for 2006 compared to 2005. The decrease in 2007 reflects a net decrease in Federal Home Loan Bank advances. The increase in 2006 reflects increased funding for loan growth.

Average stockholders' equity increased \$7,231,000 or 7.2% to \$108,052,000 for 2007 compared to \$100,821,000 for 2006 and followed a \$6,158,000 or 6.5% increase for 2006 compared to 2005. The increases represent net income retained in excess of dividends declared plus adjustments for unrealized gains or losses on debt and equity securities, net of taxes.

CRITICAL ACCOUNTING POLICIES

The following accounting policies are considered most critical to the understanding of our Company's financial condition and results of operations. These critical accounting policies require management's most difficult, subjective and complex judgments about matters that are inherently uncertain. Because these estimates and judgments are based on current circumstances, they may change over time or prove to be inaccurate based on actual experiences. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of a materially different financial condition and/or results of operations could reasonably be expected. The impact and any associated risks related to our critical accounting policies on our business operations is discussed throughout "Management's Discussion and Analysis of Financial Condition and Results of Operations," where such policies affect our reported and expected financial results. For a detailed discussion on the application of these and other accounting policies, see Note 1 of our consolidated financial statements.

Allowance for Loan Losses

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

Income Taxes

Our Company estimates income tax expense based on amounts expected to be owed to various tax jurisdictions. Accrued taxes represent the net estimated amount due or to be received from taxing jurisdictions either currently or in the future and are reported in other assets or other liabilities on the Consolidated Balance Sheet. In estimating accrued taxes, our Company assesses the relative merits and risks of the appropriate tax treatment considering statutory, judicial and regulatory guidance in the context of the tax position. Because of the complexity of tax laws and regulations, interpretation can be difficult and subject to legal judgment given specific facts and circumstances. It is possible that others, given the same information, may at any point in time reach different reasonable conclusions regarding the estimated amounts of accrued taxes.

Changes in the estimate of accrued taxes occur periodically due to changes in tax rates, interpretations of tax laws, the status of examinations being conducted by various taxing authorities, and newly enacted statutory, judicial and regulatory guidance that impact the relative merits and risks of tax positions. These changes, when they occur, affect accrued taxes and can be significant to the operating results of our Company. 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 applies to the fact of each matter. Our Company's state and federal income tax returns for 2004 to 2007 are open tax years. As of December 31, 2007, there were no federal or state income tax examinations in process.

Effective January 1, 2007, our Company adopted Financial Accounting Standards Board (FASB) 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 must recognize, in its financial statements, the best estimate of the impact of a tax position 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, FIN 48 requires 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 (a) reductions in deferred tax assets or increases in deferred tax liabilities or (b) increases in a liability for income taxes payable or reduction of an income tax refund receivable.

Goodwill and Other Intangible Assets

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

Our Company performs an annual review of goodwill and intangible assets for impairment to determine whether the carrying value of underlying assets may not be recoverable. Our Company measures recoverability based upon the future cash flows expected to result from the use of the underlying asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying value of the underlying asset, Our Company recognizes an impairment loss. The impairment loss recognized represents the amount by which the carrying value of the underlying asset exceeds the fair value of the underlying asset. As such adjustments become necessary, they are reflected in the results of operations in the periods in which they become known.

RESULTS OF OPERATIONS ANALYSIS

Net Interest Income

The following table provides a comparison of fully taxable equivalent earnings, including adjustments to interest income and tax expense for interest on tax-exempt loans and investments.

(Dollars expressed in thousands)

	Year Ended December 31,		
	2007	2006	2005
Interest income	\$ 74,207	71,423	57,340
Fully taxable equivalent (FTE) adjustment	997	1,009	882
Interest income (FTE basis)	75,204	72,432	58,222
Interest expense	37,175	32,766	23,673
Net interest income (FTE basis)	38,029	39,666	34,549
Provision for loan losses	1,154	1,326	1,322
Net interest income after provision for loan losses (FTE basis)	36,875	38,340	33,227
Noninterest income	10,221	8,600	7,265
Noninterest expense	35,054	30,148	25,368
Income before income taxes (FTE basis)	12,042	16,792	15,124
Income taxes	3,245	4,908	4,327
FTE adjustment	997	1,009	882
Income taxes (FTE basis)	4,242	5,917	5,209
Net income	\$ 7,800	10,875	9,915
Average total earning assets	\$1,038,274	1,031,423	985,848
Net interest margin	3.66%	3.85%	3.50%

Comparison of Years ended December 31, 2007, 2006, and 2005

Our Company's consolidated net income decreased by \$3,075,000 or 28.3% to \$7,800,000 for the year ended December 31, 2007 compared to \$10,875,000 for 2006. Our Company's net income increased by \$960,000 or 9.7% to \$10,875,000 for the year ended December 31, 2006 compared to \$9,915,000 for 2005.

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 \$1,637,000 or 4.1% to \$38,029,000 for 2007 compared to \$39,666,000 for 2006, and followed a \$5,117,000 or 14.8% increase for 2006 compared to 2005. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) increased from 3.50% for 2005 to 3.85% for 2006, and decreased to 3.66% for 2007. While our Company increased the yield earned on interest earning assets to 7.24% in 2007 versus 7.02% in 2006, this increase was more than offset by an increase in the rates paid on interest bearing liabilities to 4.08% versus 3.63% in 2006. The increase in the net interest margin in 2006 reflects both higher rates earned on net interest earning assets and a larger volume of interest earning assets than in the prior period. The increase in net interest margin in 2005 reflects increases in interest rates during 2005.

The provision for loan losses decreased \$172,000 or 12.9% to \$1,154,000 for 2007 compared to \$1,326,000 for 2006 and followed a \$4,000 or 0.3% increase for 2006 compared to 2005. The provision reflects the amounts management determined necessary to maintain the allowance for loan losses at a level that was adequate to cover probable losses in the loan portfolio. The allowance for loan losses totaled \$9,282,000 or 1.0% of loans outstanding at December 31, 2007 compared to \$9,015,000 or 1.1% of loans outstanding at December 31, 2006 and \$9,085,000 or 1.1% of loans outstanding at December 31, 2005. The allowance for loan losses expressed as a percentage of nonperforming loans was 152.5% at December 31, 2007, 177.9% at December 31, 2006 and 100.39% at December 31, 2005. Further discussion of managements' methodology related to the allowance and provision for loan losses may be found in the Lending and Credit Management section of this report.

Average Balance Sheets

The following table presents average balance sheets, net interest income, average yields of earning assets, and average costs of interest bearing liabilities on a fully taxable equivalent basis for each of the years in the three-year period ended December 31, 2007.

(Dollars expressed in thousands)

	Year Ended December 31,								
	2007			2006			2005		
	Average Balance	Interest Income/ Expense(1)	Rate Earned/ Paid(1)	Average Balance	Interest Income/ Expense(1)	Rate Earned/ Paid(1)	Average Balance	Interest Income/ Expense(1)	Rate Earned/ Paid(1)
ASSETS									
Loans: (2) (4)	\$ 848,771	\$ 65,636	7.73%	\$ 824,706	\$ 62,729	7.61%	\$ 743,382	\$ 49,437	6.65%
Investment in debt and equity securities: (3)									
Government sponsored enterprises	117,208	5,614	4.79	129,437	5,645	4.36	156,553	4,963	3.17
State and municipal	53,971	2,969	5.50	53,465	2,894	5.41	45,442	2,505	5.51
Other	5,883	312	5.30	6,818	316	4.63	6,765	259	3.83
Federal funds sold	11,313	615	5.44	14,737	748	5.08	32,195	1,019	3.17
Interest bearing deposits in other financial institutions	1,128	58	5.14	2,260	100	4.42	1,511	39	2.58
Total interest earning assets	1,038,274	75,204	7.24	1,031,423	72,432	7.02	985,848	58,222	5.91
All other assets	127,336			124,036			106,528		
Allowance for loan losses	(9,110)			(9,309)			(8,630)		
Total assets	<u>\$1,156,500</u>			<u>\$1,146,150</u>			<u>\$1,083,746</u>		
LIABILITIES AND STOCKHOLDERS' EQUITY									
NOW accounts	\$ 110,658	\$ 1,482	1.34%	\$ 106,605	\$ 1,390	1.30%	\$ 125,303	\$ 1,666	1.33%
Savings	46,634	260	0.56	52,137	298	0.57	55,826	319	0.57
Money market	159,767	5,668	3.55	157,643	5,186	3.29	145,004	3,618	2.5
Time deposits of \$100,000 and over	141,645	7,045	4.97	122,594	5,251	4.28	105,661	3,330	3.15
Other time deposits	318,469	14,826	4.66	314,966	12,466	3.96	292,721	8,741	2.99
Total time deposits	777,173	29,281	3.77	753,945	24,591	3.26	724,515	17,674	2.44
Federal funds purchased and securities sold under agreements to repurchase	31,061	1,381	4.45	42,350	1,811	4.28	46,265	1,256	2.71
Interest — bearing demand notes to U.S. Treasury	205	11	5.37	704	31	4.4	696	20	2.87
Subordinated notes	49,486	3,617	7.31	49,486	3,528	7.13	44,614	2,747	6.16
Other borrowed money	53,626	2,885	5.38	56,757	2,805	4.94	48,430	1,976	4.08
Total interest - bearing liabilities	911,551	37,175	4.08	903,242	32,766	3.63	864,520	23,673	2.74
Demand deposits	126,708			132,912			117,840		
Other liabilities	10,189			9,175			6,723		
Total liabilities	1,048,448			1,045,329			989,083		
Stockholders' equity	108,052			100,821			94,663		
Total liabilities and stockholders' equity	<u>\$1,156,500</u>			<u>\$1,146,150</u>			<u>\$1,083,746</u>		
Net interest income		<u>\$ 38,029</u>			<u>\$ 39,666</u>			<u>\$ 34,549</u>	
Net interest margin			<u>3.66%</u>			<u>3.85%</u>			<u>3.50%</u>

- (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 \$997,000, \$1,009,000 and \$882,000 for the years ended December 31, 2007, 2006 and 2005, respectively.
- (2) Nonaccruing loans are included in the average amounts outstanding.

- (3) Average balances based on amortized cost.
- (4) Fees and costs on loans are included in interest income.

Rate 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)

	Year Ended December 31, 2007 Compared to December 31, 2006			Year Ended December 31, 2006 Compared to December 31, 2005		
	Total Change	Change due		Total Change	Change due	
		Volume	Rate		Volume	Rate
Interest income on a fully taxable equivalent basis:						
Loans: (1) (3)	\$ 2,907	1,850	1,057	\$ 13,292	5,745	7,547
Investment in debt and equity securities:						
Government sponsored entities	(31)	(558)	527	682	(962)	1,644
State and municipal(2)	75	27	48	389	435	(46)
Other	(4)	(46)	42	57	2	55
Federal funds sold	(133)	(183)	50	(271)	(711)	440
Interest bearing deposits in other financial Institutions	(42)	(56)	14	61	25	36
Total interest income	2,772	1,034	1,738	14,210	4,534	9,676

Continued on next page

	Year Ended December 31, 2007 Compared to December 31, 2006			Year Ended December 31, 2006 Compared to December 31, 2005		
	Total Change	Change due		Total Change	Change due	
		Volume	Rate		Volume	Rate
Interest expense:						
NOW accounts	92	54	38	(276)	(245)	(31)
Savings	(38)	(30)	(8)	(21)	(21)	—
Money market	482	71	411	1,568	336	1,232
Time deposits of \$100,000 and over	1,794	881	913	1,921	593	1,328
Other time Deposits	2,360	140	2,220	3,725	705	3,020
Federal funds purchased and securities sold under agreements to repurchase	(430)	(500)	70	555	(114)	669
Interest-bearing demand notes to U.S. Treasury	(20)	(26)	6	11	—	11
Subordinated notes	89	—	89	781	319	462
Other borrowed money	80	(160)	240	829	372	457
Total interest expense	4,409	430	3,979	9,093	1,945	7,148
Net interest income on a fully taxable equivalent basis	\$ (1,637)	604	(2,241)	\$ 5,117	2,589	2,528

- (1) Nonaccruing loans are included in the average amounts outstanding.
- (2) 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 \$997,000, \$1,009,000 and \$882,000 for the years ended December 31, 2007, 2006 and 2005, respectively.
- (3) Fees and costs on loans are included in interest income.

Provision for loan losses

The provision for loan losses for 2007 was \$1,154,000 compared to \$1,326,000 for 2006. Loans charged off, net of recoveries, for 2007 were \$887,000 compared to \$1,396,000 for 2006. Approximately \$373,000 of the 2007 net charge-offs is represented by various commercial loans, \$358,000 is represented by real estate loans, and approximately \$156,000 is represented by various consumer loans.

The provision for loan losses for 2006 was \$1,326,000 compared to \$1,322,000 for 2005. Loans charged off, net of recoveries for 2006 were \$1,396,000 compared to \$1,151,000 for 2005. Approximately \$603,000 of the 2006 net charge-offs is represented by various commercial loans, \$454,000 is represented by real estate loans, and approximately \$339,000 is represented by various consumer credits.

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

Years Ended December 31, 2007 and 2006

Noninterest Income and Expense

Noninterest income and noninterest expense for the years ended December 31, 2007 and 2006 were as follows:

(Dollars expressed in thousands)

	Year Ended December 31,		Increase (decrease)	
	2007	2006	Amount	%
Noninterest Income				
Service charges on deposit accounts	\$ 5,394	5,730	(336)	(5.9%)
Trust department income	968	799	169	21.2
Mortgage loan servicing fees, net	341	433	(92)	(21.2)
Gain on sales of mortgage loans	666	432	234	54.2
Loss on sales and calls of debt securities	(2)	(18)	16	(88.9)
Other	2,854	1,224	1,630	133.2
	<u>\$ 10,221</u>	<u>8,600</u>	<u>1,621</u>	<u>18.8%</u>
Noninterest Expense				
Salaries and employee benefits	\$ 18,733	17,019	1,714	10.1%
Occupancy expense, net	2,202	1,994	208	10.4
Furniture and equipment expense	2,879	2,301	578	25.1
Legal, examination, and professional fees	1,583	1,431	152	10.6
Advertising and promotion	1,196	897	299	33.3
Postage, printing, and supplies	1,297	1,147	150	13.1
Impairment and other real-estate owned expense	681	119	562	472.3
Processing expense	1,470	1,009	461	45.7
Amortization of intangible assets	922	1,033	(111)	(10.7)
Other	4,091	3,198	893	27.9
	<u>\$ 35,054</u>	<u>30,148</u>	<u>4,906</u>	<u>16.3%</u>

As discussed in our Company's description of business, our Company completed its plan to consolidate four bank subsidiary charters under one charter in October 2007. The plan also included re-branding the name and logo, a major communications network conversion, outsourcing of data processing, and implementing new technologies such as remote capture. As a result of these events, noninterest expense reflects approximately \$1,207,000 in nonrecurring expenses as noted in more detail below. Offsetting these additional expenses were the sales of three of our subsidiary bank charters to other institutions for \$1,200,000 included in other noninterest income.

Noninterest income increased \$1,621,000 or 18.8% to \$10,221,000 for 2007 compared to \$8,600,000 for 2006. Trust department income increased \$169,000 or 21.2% due primarily to the collection of more transactional based distribution fees during 2007 compared to 2006. Mortgage loan servicing fees decreased \$91,000 or 21.2% to \$341,000 compared to \$432,000 as a result in a decrease in the amount of mortgage loans serviced. Our Company was servicing \$209,734,000 of mortgage loans at December 31, 2007 compared to \$215,701,000 at December 31, 2006. Gain on sales of mortgage loans increased \$234,000 or 54.2% due to an increase in volume of loans originated and sold to the secondary market from approximately \$39,575,000 in 2007 to approximately \$38,768,000 in 2006. Even though the volume of loans originated and sold has increased over the comparable period in the prior year, our total loan serving portfolio declined due to both increased prepayments of existing loans and an increase in the volume of loans sold without retention of the servicing rights. Our Company recognized \$2,000 in loss on sales and calls of debt securities during the 2007 compared to \$18,000 during 2006. Other income increased \$1,629,000 or 133.0%. \$1,200,000 of the increase represents the amount received from the sales of Osage Valley Bank, Bank 10, and Exchange National Bank's bank charters and \$254,000 of the increase reflects recovery of prior years' legal and collection costs as a result of settlement of a lawsuit in our Company's favor.

Noninterest expense increased \$4,906,000 or 16.3% to \$35,054,000 for 2007 compared to \$30,148,000 for 2006. Salaries and benefits increased \$1,714,000 or 10.1%, furniture and equipment expense increased \$578,000 or 25.1%, advertising and promotion increased \$299,000 or 33.3%, other real-estate owned loan expense increased \$562,000 or 472.3%, processing expense increased \$461,000 or 45.7% and other noninterest expense increased \$893,000 or 27.9%. Salaries and benefits reflects \$290,000 decrease in management's estimate of anticipated incentive payments, profit sharing and pension contributions for 2007 versus 2006. Excluding this decrease, salaries and employee benefits increased \$2,004,000 or 11.8%. This 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 \$578,000 increase in furniture and equipment expense primarily reflects \$324,000 loss on dispositions of furniture and equipment resulting from software and equipment becoming obsolete after our Company completed a major network conversion. The remaining increase is a result of two new Clinton branch facilities opening during the fourth quarter of 2007. The \$299,000 increase in advertising and promotion reflects nonrecurring costs associated with the re-branding of our Company's name and logo. The \$562,000 increase in other real-estate owned expense represents \$378,000 impairment write-down on two properties in other real-estate owned and an \$184,000 increase in additional expenses related to properties in other real estate. The \$461,000 increase in processing expense reflects nonrecurring costs associated with the merger of the bank subsidiaries and software and network conversion. The \$893,000 increase in other noninterest expense reflects expenses in various other categories including, but not limited to, conversion costs, travel, meals and entertainment, security, telephone and internet, directors fees, and insurance.

Income taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 29.4% for 2007 compared to 31.1% for 2006. The decrease in the effective tax rate for 2007 is due to an increase in non-taxable income as a percentage of total income in the current year and a decrease in income before taxes. In addition, our Company reorganized its corporate structure in the 4th quarter of 2007. This change in structure resulted in an increase in deferred tax assets at December 31, 2007 and a corresponding decrease in current state tax expense for the year then ended. As a result of this change in structure, our Company anticipates an increase in state income tax expense in future periods and a corresponding increase in the overall effective income tax rate.

Fourth Quarter Results for 2007

As mentioned above, our Company experienced higher noninterest expenses in the fourth quarter 2007 compared to third quarter 2007 and fourth quarter 2006 resulting from several events that took place during the fourth quarter 2007. A communications network conversion was completed, our data processing operation was outsourced and converted to a new system, a remote item capture system was installed to facilitate the outsourced data processing environment, and two Clinton branch locations were opened while two older Clinton locations were closed. These nonrecurring costs caused significant increases in furniture and equipment expense, advertising and promotion, processing expense, security, and conversion errors and omission. Other significant increases in noninterest expense were seen in real estate loan collection expenses, other real estate owned impairment charges, and donations.

Comparing fourth quarter 2007 to third quarter 2007:

Our Company's net income of \$993,000 for the fourth quarter ended December 31, 2007 declined \$1,144,000, compared to \$2,137,000 for the third quarter ended September 30, 2007. Net interest income of \$9,486,000 increased \$161,000 from third quarter 2007 due to an increase in net interest margin due to higher average earning assets and a decrease in the rates paid on interest bearing liabilities during the current period.

The fourth quarter 2007 provision for loan losses of \$550,000 was \$325,000 higher than third quarter 2007's provision of \$225,000 and was based upon management's determination of the loan loss reserve required to cover probable losses in the loan portfolio at year-end.

Noninterest income of \$2,753,000 for fourth quarter 2007 increased \$658,000 from third quarter 2007's noninterest income of \$2,095,000. \$325,000 of this increase represented funds received from the sale of the third bank charter that was available as the result of our consolidation project. The remaining increase represented higher fees in service charge income and trust department income.

Noninterest expense of \$10,313,000 for fourth quarter 2007 increased \$2,152,000 from third quarter 2007's noninterest expense of \$8,161,000.

Furniture and equipment expenses increased \$444,000 from \$638,000 for the third quarter of 2007 to \$1,082,000 for the fourth quarter. \$324,000 of this increase reflects a loss on disposition of obsolete furniture and equipment resulting from our completion of the major network and data processing conversion during the fourth quarter. The remaining increase is a result of two new Clinton branch facilities opened during the fourth quarter of 2007. Advertising and promotion increased \$242,000 from \$309,000 for the third quarter of 2007 to \$551,000 for the fourth quarter and reflects nonrecurring costs associated with the re-branding of our Company's name and logo. Processing expenses increased \$267,000 from \$325,000 for the third quarter of 2007 to \$592,000 for the fourth quarter primarily due to final billings for the communication network and data processing conversion. Conversion related charge-offs of unreconciled differences increased \$128,000 from \$68,000 third quarter 2007 to \$196,000 for the fourth quarter. Other real-estate owned loan expenses increased \$558,000 from \$33,000 third quarter 2007 to \$591,000 for the fourth quarter. Our Company recognized \$378,000 of impairment losses on two parcels of other real estate owned and incurred additional expenses related to properties in other real estate owned. Donations increased from \$66,000 third quarter 2007 to \$147,000 for the fourth quarter due to payment of charitable contribution commitments at year-end.

Comparing fourth quarter 2007 to fourth quarter 2006:

Our Company's net income of \$993,000 for the fourth quarter ended December 31, 2007 declined \$1,402,000, compared to net income of \$2,395,000 for the fourth quarter ended December 31, 2006. Fourth quarter 2007 net interest income decreased \$153,000 from fourth quarter ended December 31, 2006 due to a lower net interest margin resulting from an increase in the rates paid on interest bearing liabilities from 2006 to 2007.

The fourth quarter 2007 provision for loan losses of \$550,000 was \$152,000 higher than fourth quarter 2006's provision of \$398,000 and was based upon management's determination of the loan loss reserve required to cover probable losses in the loan portfolio at year-end.

Noninterest income of \$2,753,000 for fourth quarter 2007 increased \$644,000 from fourth quarter 2006's noninterest income of \$2,109,000. \$325,000 of this increase represented funds received from the sale of the third bank charter that was available as the result of our consolidation project. The remaining increase represented higher fees in service charge income and trust department income.

Noninterest expense of \$10,313,000 for fourth quarter 2007 increased \$2,416,000 from fourth quarter 2006's noninterest expense of \$7,897,000.

Salaries and employee benefits increased \$502,000 from \$4,077,000 for the fourth quarter 2006 to \$4,579,000 for the fourth quarter 2007. Salaries and benefits reflects \$290,000 decrease in management's estimate of anticipated incentive payments, profit sharing and pension contributions for 2007 versus 2006. Excluding this decrease, salaries and employee benefits increased \$795,000 which 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. Variances in other categories of noninterest expense between the two periods are the result of the events described in the preceding section.

Years Ended December 31, 2006 and 2005

Noninterest Income and Expense

Noninterest income and noninterest expense for the years ended December 31, 2006 and 2005 were as follows:

(Dollars expressed in thousands)

	Year Ended December 31,		Increase (decrease)	
	2006	2005	Amount	%
Noninterest Income				
Service charges on deposit accounts	\$ 5,730	4,245	1,485	35.0%
Trust department income	799	810	(11)	(1.4)
Mortgage loan servicing fees, net	433	427	6	(1.4)
Gain on sales of mortgage loans	432	676	(244)	(36.1)
Loss on sales and calls of debt securities	(18)	(25)	7	(28.0)
Other	1,224	1,132	92	8.1
	<u>\$ 8,600</u>	<u>7,265</u>	<u>1,335</u>	<u>18.4%</u>
Noninterest Expense				
Salaries and employee benefits	\$ 17,019	13,920	3,099	22.3%
Occupancy expense, net	1,995	1,600	395	24.7
Furniture and equipment expense	2,301	2,150	151	7.0
Legal, examination, and professional fees	1,431	1,420	11	0.8
Advertising and promotion	897	819	78	9.5
Postage, printing, and supplies	1,147	976	171	17.5
Processing expense	1,009	751	258	34.4
Amortization of intangible assets	1,033	807	226	28.0
Other	3,316	2,925	391	13.4
	<u>\$ 30,148</u>	<u>25,368</u>	<u>4,780</u>	<u>18.8%</u>

Noninterest income increased \$1,335,000 or 18.4% to \$8,600,000 for 2006 compared to \$7,265,000 for 2005. Approximately \$890,000 of the increase in noninterest income is attributed to the acquisition of Bank 10. Bank 10 contributed a full year of noninterest income during 2006 compared to eight months in 2005. Excluding noninterest income associated with the acquisition, service charge income increased \$698,000 or 22.1%. Gain on sales of mortgage loans decreased \$244,000 or 36.1% due to a decrease in volume of loans originated and sold to the secondary market from approximately \$38,768,000 in 2005 to approximately \$20,457,000 in 2005. Mortgage rates increased during 2006. As a result, there were fewer loans refinanced during 2006 and 2005 resulting in the decreased volume of loans sold.

Noninterest expense increased \$4,780,000 or 18.8% to \$30,148,000 for 2006 compared to \$25,368,000 for 2005. Approximately \$2,253,000 of the increase in noninterest expense is attributed to the acquisition of Bank 10. Bank 10 contributed a full year of noninterest income during 2006 compared to eight months in 2005. Excluding costs associated with the acquisition, salaries and benefits increased \$1,683,000 or 14.3%, occupancy expense increased \$213,000 or 16.7%, postage, printing and supplies increased \$99,000 or 13.0%, processing expense increased \$121,000 or 22.2% and other noninterest expense increased \$295,000 or 11.4%. In addition to the increase in salaries and employee benefits represented by normal salary increases and additional hire, \$218,000 of the increase reflects share-based compensation expense recorded as a result of the adoption of SFAS No. 123R, \$254,000 reflects increased pension expense, and \$187,000 reflects increased profitsharing expense. The increase in occupancy expense primarily reflects additional costs associated with three new branch facilities. The increase in postage, printing and supplies reflects both higher postage rates and additional mail volume. The increase in processing expense reflects higher cost associated with various data processing systems utilized by our Company.

Income taxes

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 31.1% for 2006 compared to 30.4% for 2005. The increase in the effective tax rate is due to an decrease in state taxable income as a percentage of total income in the current year.

Lending and Credit Management

Interest earned on the loan portfolio is a primary source of interest income for our Company. Net loans represented 75.4% of total assets as of December 31, 2007. Total loans increased steadily from December 31, 2005 through December 31, 2007 due to relatively stable local economies and reasonable interest rates as well as an expanded branch network.

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

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

(Dollars expressed in thousands)

	December 31,									
	2007		2006		2005		2004		2003	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial, financial and agricultural	\$151,488	16.6%	\$145,697	17.9%	\$154,868	19.0%	\$141,151	22.2%	\$130,931	22.4%
Real estate — Construction	147,432	16.2	150,891	16.6	139,316	17.2	65,075	8.0	46,672	7.3
Real estate — Mortgage	575,552	63.2	478,854	52.6	480,531	59.2	392,656	48.3	364,620	57.3
Installment loans to individuals	36,806	4.0	36,870	4.0	38,820	4.8	37,755	4.6	41,696	6.5
Total loans	\$911,278	100.0%	\$812,312	100.0%	\$813,535	100.0%	\$636,637	100.0%	\$583,919	100.0%

Our Company experienced loan growth of \$98,966,000 or 12.2% from 2006 to 2007. This growth is primarily in our Bank's commercial and real estate mortgage lending. Commercial loans increased \$5,791,000 or 4.0% from 2006 to 2007 and real estate loans increased \$96,698,000 or 20.2%. The increase in our Company's commercial loan portfolio occurred throughout our Bank's regions. This growth was the result of management's intent to increase the variable rate asset base. The growth in the real estate mortgage area was primarily the result of our Company's expansion into the Columbia, Missouri market. Additionally, our Company is continuing to experience loan growth in the Branson and Springfield, Missouri markets as a result of lending for investment and income producing properties. These properties generate a measurable cash flow that can be monitored and supports the extension of credit. Our Company's lending activities in the real estate construction market decreased \$3,459,000 or 2.3% from 2006 to 2007 due to the slow down in the housing industry and residential construction industry. Management anticipates that construction lending will be closely monitored during 2008.

The \$9,171,000 decrease in commercial loans between December 31, 2005 and December 31, 2006 reflects the payoff of two loans for approximately \$3,297,000 that were classified as impaired at December 31, 2005. Our Company recognized an additional charge-off of \$315,000 on one of those credits during 2006. An additional \$1,862,000 represents the payoff of one credit that moved to the commercial finance market. \$3,711,000 represents reductions in lines of credits of various other borrowers. The \$11,575,000 increase in real estate construction loans is primarily represented by two large commercial construction projects in the Kansas City area. \$12,062,000 of the increase in Commercial, Financial and Agricultural loans between December 31, 2004 and December 31, 2005 reflects the loans of Bank 10. \$48,895,000 of the increase in Real Estate Construction loans and \$75,168,000 of the increase in Real Estate Mortgage loans reflects loans of Bank 10.

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

Loans at December 31, 2007 mature as follows:

(Dollars expressed in thousands)

	One Year Or Less	Over One Year Through Five Years		Over Five Years		Total
		Fixed Rate	Floating Rate	Fixed Rate	Floating Rate	
Commercial, financial, and agricultural	\$ 86,204	\$ 26,179	\$ 35,756	\$ 449	\$ 2,900	\$ 151,488
Real estate — construction	147,432	—	—	—	—	147,432
Real estate — mortgage	135,314	311,850	51,555	34,165	42,668	575,552
Installment loans to individuals	19,024	16,875	177	635	95	36,806
Total loans	<u>\$ 387,974</u>	<u>\$ 354,904</u>	<u>\$ 87,488</u>	<u>\$ 35,249</u>	<u>\$ 45,663</u>	<u>\$ 911,278</u>

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 December 31, 2007 our Company was servicing approximately \$209,000,000 of loans sold to the secondary market.

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

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

Management, through the establishment of a senior loan committee, formally reviews all loans in excess of certain dollar amounts (periodically established) at least annually. Currently, loans in excess of \$1,000,000 in aggregate and all adversely classified credits identified by management as containing more than usual risk are reviewed. On a monthly basis, the senior loan committee reviews and reports to the Board of Directors past due, "classified", and "watch list" loans in order to classify or reclassify loans as "loans requiring attention," "substandard," "doubtful," or "loss". During this review, management also determines what loans should be considered "impaired". Management follows the guidance provided in Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, (SFAS 114) in identifying and measuring loan impairment. If management determines that it is probable that all amounts due on a loan will not be collected under the original terms of the loan agreement the loan is considered to be impaired. Once a loan has been identified as impaired management generally measures impairment based upon the fair value of the underlying collateral. Management believes, but there can be no assurance, that these procedures keep management informed of possible problem loans. Based upon these procedures, both the allowance and provision for loan losses are adjusted to maintain the allowance at a level considered adequate by management for probable losses inherent in the loan portfolio.

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

(Dollars expressed in thousands)

	Year Ended December 31,				
	2007	2006	2005	2004	2003
Analysis of allowance for loan losses:					
Balance beginning of year	\$ 9,015	9,085	7,496	8,267	7,121
Allowance for loan losses of acquired companies at date of acquisitions	—	—	1,418	—	212
Charge-offs:					
Commercial, financial, and agricultural	524	809	589	1,596	58
Real estate — construction	56	84	185	—	—
Real estate — mortgage	413	474	286	26	86
Installment loans to individuals	314	484	261	236	340
Total charge-offs	1,307	1,851	1,321	1,858	484
Recoveries:					
Commercial, financial, and agricultural	151	206	40	18	164
Real estate — construction	11	13	—	—	—
Real estate — mortgage	100	91	28	—	—
Installment loans to individuals	158	145	102	127	162
Total recoveries	420	455	170	145	326
Net charge-offs	887	1,396	1,151	1,713	158
Provision for loan losses	1,154	1,326	1,322	942	1,092
Balance at end of year	<u>\$ 9,282</u>	<u>9,015</u>	<u>9,085</u>	<u>7,496</u>	<u>8,267</u>
Loans outstanding:					
Average	\$ 848,772	824,706	743,382	601,363	539,912
End of period	911,278	812,312	813,535	636,637	583,919
Allowance for loan losses to loans outstanding:					
Average	1.09%	1.09	1.22	1.25	1.53
End of period	1.02	1.11	1.12	1.18	1.42
Net charge-offs to average loans outstanding	0.10	0.17	0.15	0.29	0.03

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

(Dollars expressed in thousands)

	Year Ended December 31,				
	2007	2006	2005	2004	2003
Allocation of allowance for loan losses at end of period:					
Commercial, financial, and agricultural	\$ 3,762	3,114	2,687	3,700	3,979
Real estate — construction	590	755	764	288	201
Real estate — mortgage	3,873	3,526	4,138	2,563	2,538
Installment loans to individuals	419	529	473	429	561
Unallocated	638	1,091	1,023	516	988
Total	<u>\$ 9,282</u>	<u>9,015</u>	<u>9,085</u>	<u>7,496</u>	<u>8,267</u>
Percent of categories to total loans:					
Commercial, financial, and agricultural	16.6%	17.9	19.0	22.2	22.4
Real estate — construction	16.2	18.6	17.1	10.2	8.0
Real estate — mortgage	63.2	59.0	59.1	61.7	62.5
Installment loans to individuals	4.0	4.5	4.8	5.9	7.1
Total	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Nonperforming loans, defined as loans on nonaccrual status, loans 90 days or more past due, and restructured loans totaled \$6,085,000 or 0.67% of total loans at December 31, 2007 compared to \$5,066,000 or 0.62% of total loans at December 31, 2006. The following table summarizes our Company's nonperforming assets at the dates indicated:

(Dollars expressed in thousands)

	December 31,				
	2007	2006	2005	2004	2003
Nonaccrual loans:					
Commercial, financial, and agricultural	\$ 2,983	2,495	5,705	4,213	1,520
Real estate — construction	866	1,657	1,760	—	59
Real estate — mortgage	658	644	1,090	1,246	1,270
Installment loans to individuals	32	73	56	30	55
Total nonaccrual loans	4,539	4,869	8,611	5,489	2,904
Loans contractually past — due 90 days or more and still accruing:					
Commercial, financial, and agricultural	454	5	238	12	66
Real estate — construction	158	—	—	—	—
Real estate — mortgage	864	170	187	591	4
Installment loans to individuals	70	22	14	—	40
Total loans contractually past -due 90 days or more and still accruing	1,546	197	439	603	110
Restructured loans	—	—	—	—	—
Total nonperforming loans	6,085	5,066	9,050	6,092	3,014
Other real estate	2,337	2,720	1,568	30	47
Repossessions	—	15	—	42	73
Total nonperforming assets	\$ 8,422	7,801	10,618	6,164	3,134
Loans	\$ 911,278	812,313	813,535	636,637	583,919
Allowance for loan losses to loans	1.02%	1.11	1.12	1.18	1.42
Nonperforming loans to loans	0.67	0.62	1.11	0.96	0.52
Allowance for loan losses to nonperforming loans	152.54	177.95	100.39	123.05	274.29
Nonperforming assets to loans and foreclosed assets	0.92	0.96	1.30	0.97	0.54

As can be seen from the preceding table, our Company's 2007 year-end nonperforming assets of \$8,422,000 increased slightly from the 2006 year-end total of \$7,801,000 and decreased significantly from the 2005 year-end total of \$10,618,000. Nonaccrual loans decreased by \$330,000 at December 31, 2007 and followed a \$3,742,000 decrease from December 31, 2005 to December 31, 2006. However our Company has experienced an increase in loans that are contractually past-due 90 days or more and still accruing. Loans in this category increased \$1,049,000 to \$1,546,000 at December 31, 2007 compared to \$197,000 at December 31, 2006 and \$497,000 at December 31, 2005. Our Company has experienced an increase in its loan delinquencies much like the rest of the banking industry as current economic conditions negatively impact our borrowers' ability to keep their debt payments current. While these delinquencies are primarily in the less than thirty day past due category, management believes close monitoring of these credits will mitigate potential higher delinquency levels and/or losses. Management believes these loans are well secured and is actively focused on managing and collecting these accounts to prevent further deterioration.

It is our Company's policy to discontinue the accrual of interest income on loans when the full collection of principal or interest is in doubt, or when the payment of principal or interest has become contractually 90 days past due unless the obligation is both well secured and in the process of collection. Subsequent interest payments received on such loans are applied to principal if any doubt exists as to the collectibles of such principal; otherwise, such receipts are recorded as interest income. Interest on year-end nonaccrual loans, which would have been recorded under the original terms of the loans, was approximately \$745,000, \$896,000 and \$767,000 for the years ended December 31, 2007, 2006 and 2005, respectively. Approximately \$330,000, \$63,000 and \$253,000 was actually recorded as interest income on such loans for the year ended December 31, 2007, 2006 and 2005, 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 at December 31, 2007 included in the table above, which were considered impaired, management has identified additional loans totaling approximately \$4,027,000 which are not included in the nonaccrual table above but are considered by management to be impaired compared to \$9,187,000 in December 31, 2006.

Once a loan has been identified as impaired (as defined by paragraph 8 of SFAS 114), *Accounting by Creditors for Impairment of a Loan*, management generally measures impairment based upon the fair value of the underlying collateral. In general, market prices for loans in our portfolio are not available, and we have found the fair value of the underlying collateral to be more readily available and reliable than discounting expected future cash flows to be received. Once a fair value of collateral has been determined and the impairment amount calculated, a specific reserve allocation is made. At December 31, 2007, \$3,256,000 of our Company's allowance for loan losses was allocated to impaired loans totaling approximately \$8,565,000.

As of December 31, 2007 and 2006 approximately \$11,645,000 and \$7,102,000, respectively, of loans not included in the nonaccrual table above or identified by management as being "impaired" were classified by management as having more than normal risk which raised doubts as to the ability of the borrower to comply with present loan repayment terms. The \$4,543,000 increase in classified loans is the result of several borrowers who have experienced cash flow problems and as well as some deterioration in collateral value. Management elected to allocate non-specific reserves to these credits based upon the inherent risk present. This increase in reserves was the result of our Company's internal loan review process which assesses credit risk. In addition to the classified list, our Company also maintains an internal loan watch list of loans which for various reasons, not all related to credit quality, management is monitoring more closely than the average loan in the portfolio. Loans may be added to this list for reasons which are temporary and correctable, such as the absence of current financial statements of the borrower, or a deficiency in loan documentation. Other loans are added as soon as any problem is detected which might affect the borrower's ability to meet the terms of the loan. This could be initiated by the delinquency of a scheduled loan payment, deterioration in the borrower's financial condition identified in a review of periodic financial statements, a decrease in the value of the collateral securing the loan, or a change in the economic environment within which the borrower operates. Once a loan is placed on our Company's watch list, its condition is monitored closely. Any further deterioration in the condition of the loan is evaluated to determine if the loan should be assigned to a higher risk category.

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

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

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

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

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

At December 31, 2007, management allocated \$8,644,000 of the \$9,282,000 total allowance for loan losses to specific loans and loan categories and \$638,000 was unallocated. Considering the size of several of our Company's lending relationships and the loan portfolio in total, management believes that the December 31, 2007 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.

Investment Portfolio

Our Company classifies its debt and equity securities into one of the following two categories:

Held-to-Maturity — includes investments in debt securities which our Company has the positive intent and ability to hold until maturity.

Available-for-Sale — includes investments in debt and equity securities not classified as held to maturity or trading (i.e., investments which our Company has no present plans to sell in the near-term but may be sold in the future under different circumstances).

Debt securities classified as held-to-maturity are carried at amortized cost, while debt and equity securities classified as trading or available-for-sale are carried at estimated market value. Unrealized holding gains and losses from available-for-sale securities are excluded from earnings and reported, net of applicable taxes, as a separate component of stockholders' equity until realized.

Our Company does not engage in trading activities and accordingly does not have any debt or equity securities classified as trading securities. Historically our Company's practice had been to purchase and hold debt instruments until maturity unless special circumstances exist. However, since the investment portfolio's major function is to provide liquidity and to balance our Company's interest rate sensitivity position, certain debt securities are classified as available-for-sale.

At December 31, 2007, debt and equity securities classified as available-for-sale represented 13.2% of total consolidated assets. Future levels of held-to-maturity and available-for-sale investment securities can be expected to vary depending upon liquidity and interest sensitivity needs as well as other factors.

The following table presents the composition of the investment portfolio by major category.

(Dollars expressed in thousands)

	2007 Available - for-Sale	2006 Available - for-Sale	2005 Available - for-Sale
U.S. Treasuries	\$ —	\$ 1,068	\$ —
Government sponsored enterprises	87,370	121,769	113,005
Asset-backed securities	10,892	5,068	6,250
Obligations of states and political subdivisions	53,480	55,661	53,426
Other debt securities	—	—	708
Total debt securities	151,742	183,566	173,389
Federal Home Loan Bank of Des Moines Stock	3,979	3,808	3,904
Federal Reserve Bank Stock	—	752	752
Midwest Independent Bank Stock	151	151	151
Federal Agricultural Mortgage Corporation	10	10	10
Other equity securities	1,486	1,486	1,486
Total investments	\$ 157,368	\$ 189,773	\$ 179,692

As of December 31, 2007, the maturity of debt securities in the investment portfolio was as follows:

(Dollars expressed in thousands)

Available-for-Sale	One Year Or Less	Over One Through Five Years	Over Five Through Ten Years	Over Ten Years	Weighted Average Yield (1)
Government sponsored enterprises	\$ 37,798	\$ 42,988	\$ 6,335	\$ 250	4.70%
Asset-backed (2)	507	6,977	3,408	—	4.92
States and political subdivisions (3)	3,440	17,354	21,233	11,452	5.38
Total available-for-sale debt securities	\$ 41,745	\$ 67,319	\$ 30,976	\$ 11,702	4.95%
Weighted average yield (1)	4.63%	4.94%	5.28%	5.28%	

(1) Weighted average yield is based on amortized cost.

(2) Asset-backed securities have been included using historic repayment speeds. Repayment speeds were determined from actual portfolio experience during the twelve months ended December 31, 2007 calculated separately for each mortgage-backed security. These repayment speeds are not necessarily indicative of future repayment speeds and are subject to change based on changing mortgage interest rates.

(3) Rates on obligations of states and political subdivisions have been adjusted to fully taxable equivalent rates using the statutory Federal income tax rate of 35%.

At December 31, 2007, \$5,230,000 of debt securities classified as available-for-sale in the table above had variable rate provisions with adjustment periods ranging from one week to twelve months.

Risk Management

Market risk arises from exposure to changes in interest rates and other relevant market rate or price risk. Our Company faces market risk in the form of interest rate risk through transactions other than trading activities. Market risk from these activities, in the form of interest rate risk, is measured and managed through a number of methods. Our Company uses financial modeling techniques to measure interest rate risk. These techniques measure the sensitivity of future earnings due to changing interest rate environments. Guidelines established by our Company's Asset/Liability Management Committee and approved by our Company's Board of Directors are used to monitor exposure of earnings at risk. General interest rate movements are used to develop sensitivity as our Company feels it has no primary exposure to a specific point on the yield curve. For the year ended December 31, 2007, our Company utilized both a 200 basis point immediate and gradual move in interest rates (both upward and downward) applied to both a parallel and a proportional yield curve. Due to the significant movements in interest rate experienced during 2007, our Company anticipates using a 300 basis point change in interest rates in its interest rate risk model during 2008.

Interest Sensitivity

At December 31, 2007, our Company monitored its static gap report with the goal being to limit potential changes in net interest income due to changes in interest rates to acceptable limits. Our Company applied a plus or minus 2.00% interest rate change utilizing both an immediate and a gradual interest shock and measured against both parallel and proportional yield curves. The resulting net interest income changes ranged from approximately (14.5)% to 11.5% depending on the scenario.

The following table represents the estimated interest rate sensitivity and periodic and cumulative gap positions calculated as of December 31, 2007. Significant assumptions used for this table included: loans will repay at historic repayment rates; interest-bearing demand accounts and savings accounts are interest sensitive due to immediate repricing, and fixed maturity deposits will not be withdrawn prior to maturity. A significant variance in actual results from one or more of these assumptions could materially affect the results reflected in the table.

(Dollars expressed in thousands)

	Year 1	Year 2	Year 3	Year 4	Year 5	Over 5 years or no stated Maturity	Total
ASSETS							
Investments in debt and equity securities	\$ 63,072	30,917	20,332	9,845	4,066	29,137	157,369
Interest-bearing deposits	133	—	—	—	—	—	133
Federal funds sold and securities purchased under agreements to resell	664	—	—	—	—	—	664
Loans	496,716	119,669	168,387	36,473	52,235	28,516	901,996
Total	<u>\$560,585</u>	<u>150,586</u>	<u>188,719</u>	<u>46,318</u>	<u>56,301</u>	<u>57,653</u>	<u>1,060,162</u>
LIABILITIES							
Savings, Now deposits	\$ —	—	—	—	—	111,175	111,175
Rewards checking, Super Now, money market deposits	153,934	—	—	—	—	64,113	218,047
Time deposits	379,927	36,868	27,912	5,790	3,053	130	453,680
Federal funds purchased and securities sold under agreements to repurchase	25,730	—	—	—	—	—	25,730
Subordinated notes	25,774	—	—	23,712	—	—	49,486
Other borrowed money	48,158	12,734	16,063	576	259	125	77,915
Total	<u>\$633,523</u>	<u>49,602</u>	<u>43,975</u>	<u>30,078</u>	<u>3,312</u>	<u>175,543</u>	<u>936,033</u>
Interest-sensitivity GAP							
Periodic GAP	<u>\$ (72,938)</u>	<u>100,984</u>	<u>144,744</u>	<u>16,240</u>	<u>52,989</u>	<u>(117,890)</u>	<u>124,129</u>
Cumulative GAP	<u>\$ (72,938)</u>	<u>28,046</u>	<u>172,790</u>	<u>189,030</u>	<u>242,019</u>	<u>124,129</u>	<u>124,129</u>
Ratio of interest-earnings assets to interest-bearing liabilities							
Periodic GAP	<u>0.88</u>	<u>3.04</u>	<u>4.29</u>	<u>1.54</u>	<u>17.00</u>	<u>0.33</u>	<u>1.13</u>
Cumulative GAP	<u>0.88</u>	<u>1.04</u>	<u>1.24</u>	<u>1.25</u>	<u>1.32</u>	<u>1.13</u>	<u>1.13</u>

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 Company's Asset/Liability Committee (ALCO), primarily made up of senior management, has 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. Our Company has an insignificant amount of deposits on which the rate paid exceeded the market rate by more than 50 basis points when the account was established.

At December 31, 2007 and 2006, our Company had certificates and other time deposits in denominations of \$100,000 or more which mature as follows:

(Dollars expressed in thousands)

	December 31,	
	2007	2006
Three months or less	\$ 41,533	\$ 35,420
Over three months through six months	35,565	35,629
Over six months through twelve months	44,271	51,033
Over twelve months	18,374	13,804
	<u>\$ 139,743</u>	<u>\$ 135,886</u>

Securities sold under agreements to repurchase generally mature the next business day; however, certain agreements with local political subdivisions and select businesses are fixed rate agreements with original maturities generally ranging from 30 to 120 days. Information relating to securities sold under agreements to repurchase is as follows:

(Dollars expressed in thousands)

	At End of Period		For the Period Ending		
	Balance	Weighted Average Interest Rate	Maximum Month-end Balance	Average Balance	Weighted Average Interest Rate
December 31, 2007	\$18,365	3.24%	\$28,705	\$26,807	4.23%
December 31, 2006	27,320	4.35	56,027	41,309	4.25
December 31, 2005	33,293	3.30	63,482	45,832	2.70

Other sources of funds available to meet daily needs include the sales of securities under agreements to repurchase and funds made available under a treasury tax and loan note agreement with the federal government. Also, the Bank is a member of the Federal Home Loan Bank of Des Moines (FHLB). As a member of the FHLB, the Bank has access to credit products of the FHLB. At December 31, 2007, the amount of available credit from the FHLB totaled \$39,774,000. As of December 31, 2007, the Bank had \$77,915,000 in outstanding borrowings with the FHLB. Under agreements with unaffiliated banks, the Bank may borrow up to \$75,000,000 in federal funds on an unsecured basis and \$8,000,000 on a secured basis at December 31, 2007. As of December 31, 2007, the Bank had \$7,365,000 in federal funds purchased. Finally, our Company has \$20,000,000 line of credit with a correspondent bank that had no balance outstanding at December 31, 2007.

Our Company's liquidity depends primarily on the dividends paid to it as the sole shareholder of our subsidiary Bank. As discussed in note 3 to our Company's consolidated financial statements, the Bank may pay up to \$25,079,000 in dividends to our Company without regulatory approval subject to the ongoing capital requirements of the Bank.

In the normal course of business, our Company enters into certain forms of off-balance sheet transactions, including unfunded loan commitments and letters of credit. These transactions are managed through our Company's various risk management processes. Management considers both on-balance sheet and off-balance sheet transactions in its evaluation of our Company's liquidity. In the section entitled, "Other Off-Balance Sheet Activities", we disclose that our Company has \$147,095,000 in unused loan commitments and standby letters of credit as of December 31, 2007. While this commitment level would be difficult to fund given our Company's current liquidity resources, we know that the nature of these commitments are such that the likelihood of such a funding demand is very low.

For the years ended December 31, 2007, 2006 and 2005, net cash provided by operating activities was \$13,388,000 in 2007, \$16,637,000 in 2006, and \$16,892,000 in 2005. \$3,075,000 of the decrease between 2007 and 2006 reflects a lower level of net income. The variances in net cash provided by operating activities between 2006 and 2005 is primarily the result of differences in the timing of tax payments.

Net cash used in investing activities was \$73,439,000 in 2007, \$14,565,000 in 2006, and \$61,449,000 in 2005. The increase in cash used in investing activities from 2007 to 2006 is primarily due to 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 from maturities of debt securities. The decrease in cash used in investing activities from 2006 to 2005 is primarily due to a smaller increase in the loan portfolio as well as the purchase of Bank 10 in 2005.

Net cash provided by financing activities was \$42,925,000 in 2007, \$3,198,000 in 2006, and \$26,580,000 in 2005. The increase in cash provided by financing activities from 2007 to 2006 is primarily the result of an increase in interest-bearing transaction accounts, time deposits, and a net increase in federal home loan borrowings partially offset by a decrease in demand deposits. The reduction in cash provided by financing activities from 2006 to 2005 is primarily the result of the issuance of additional subordinated note of \$23,712,000 in 2005.

Other Off-Balance Sheet Activities

In the normal course of business, our Company is party to activities that contain credit, market and operational risk that are not reflected in whole or in part in our Company's consolidated financial statements. Such activities include traditional off-balance sheet credit related financial instruments.

Our Company provides customers with off-balance sheet credit support through loan commitments and standby letters of credit. Summarized credit-related financial instruments, including both commitments to extend credit and letters of credit at December 31, 2007 are as follows:

(Dollars expressed in thousands)

	Amount of Commitment Expiration per Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	Over 5 Years
Unused loan commitments	\$141,414	\$23,438	\$93,954	\$10,057	\$13,965
Standby letters of credit	5,681	4,076	119	1,486	—

Since many of the unused commitments are expected to expire or be only partially used, the total amount of commitments in the preceding table does not necessarily represent future cash requirements.

Contractual Cash Obligations

The required payments of time deposits and other borrowed money, not including interest, at December 31, 2007 are as follows:

(Dollars expressed in thousands)

	Payments due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	Over 5 Years
Time deposits	\$453,680	\$379,927	\$64,780	\$8,843	\$130
Other borrowed money	77,915	48,158	28,797	834	126

Capital

Risk-based capital guidelines for financial institutions were adopted by regulatory authorities effective January 1, 1991. These guidelines are designed to relate regulatory capital requirements to the risk profiles of the specific institutions and to provide more uniform requirements among the various regulators. Our Company is required to maintain a minimum risk-based capital to risk-weighted assets ratio of 8.00%, with at least 4.00% being "Tier 1" capital. In addition, a minimum leverage ratio, Tier 1 capital to adjusted total assets, of 3.00% must be maintained. However, for all but the most highly rated financial institutions, a leverage ratio of 3.00% plus an additional cushion of 100 to 200 basis points is expected.

Detail concerning our Company's capital ratios at December 31, 2007 is included in Note 3 of our Company's consolidated financial statements included elsewhere in this report.

Recent Accounting Pronouncements

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

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 gives our Company the irrevocable option to carry most financial assets and liabilities at fair value that are not currently required to be measured at fair value. If the fair value option is elected, changes in fair value would be recorded in earnings at each subsequent reporting date. SFAS 159 is effective for our Company's 2008 fiscal year. Our Company is currently evaluating the impact the adoption of this statement could have on its financial condition and results of operations. However, it is not expected to have a material impact on our Company's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement*. SFAS No. 157 defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The statement does not require any new fair value measures. The statement is effective for fair value measures already required or permitted by other standards for fiscal years beginning after November 15, 2007. Our Company is required to adopt SFAS 157 beginning on January 1, 2008. SFAS 157 is required to be applied prospectively, except for certain financial instruments. Any transition adjustment will be recognized as an adjustment to opening retained earnings in the year of adoption. In November 2007, the FASB proposed a one-year deferral of SFAS No. 157's fair-value measurement requirements for nonfinancial assets and liabilities that are not

required or permitted to be measured at fair value on a recurring basis. Our Company is currently evaluating the impact of adopting SFAS No. 157 on its results of operations and financial position. However, it is not expected to have a material impact on our Company's financial position or results of operations.

In September 2006, the FASB's Emerging Issues Task Force reached a consensus on Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* (EITF 06-4). EITF 06-4 provides guidance on the accounting for arrangements in which an employer owns and controls the insurance policy and has agreed to share a portion of the cash surrender value and/or death benefit with the employee. This guidance requires an employer to record a postretirement benefit, in accordance with FASB Statement No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions* or APB Opinion No. 12, *Omnibus Opinion-1967*, if there is an agreement by the employer to share a portion of the proceeds of a life insurance policy with the employee during the postretirement period. This guidance is effective for reporting periods beginning after December 15, 2007. Our Company is currently evaluating the impact of adopting EITF 06-4 on its financial position and results of operations. However, it is not expected to have a material impact on the financial position or results of operations.

Effective January 1, 2007, our Company adopted 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 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. Our Company is using the amortized cost method of accounting for servicing assets. The adoption had no material impact on our Company's financial position or results of operations.

Effects of Inflation

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

Inflation does have an impact on the growth of total assets in the banking industry, often resulting in a need to increase capital at higher than normal rates to maintain an appropriate capital to asset ratio. In the opinion of management, inflation did not have a significant effect on our Company's operations for the three years ended December 31, 2007.

Quantitative and Qualitative Disclosures About Market Risk

Our Company's exposure to market risk is reviewed on a regular basis by our Company's Asset/Liability Committee and Board 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 Bank's management include the standard gap report subject to different rate shock scenarios. At December 31, 2007, the rate shock scenario models indicated that annual net interest income could change by as much as 14.5% should interest rates rise or fall within 200 basis points from their current level over a one year period. 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.

CONSOLIDATED FINANCIAL STATEMENTS

The following consolidated financial statements of our Company and reports of our Company's independent auditors appear on the pages indicated.

	Page
Report of Independent Registered Public Accounting Firm	33
Consolidated Balance Sheets as of December 31, 2007 and 2006	34
Consolidated Statements of Income for each of the years ended December 31, 2007, 2006 and 2005	35
Consolidated Statements of Stockholders' Equity and Comprehensive Income for each of the years ended December 31, 2007, 2006 and 2005	36
Consolidated Statements of Cash Flows for each of the years ended December 31, 2007, 2006 and 2005	37
Notes to Consolidated Financial Statements	38

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Hawthorn Bancshares, Inc.:

We have audited the accompanying consolidated balance sheets of Hawthorn Bancshares, Inc. and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Hawthorn Bancshares, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Hawthorn Bancshares, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 14, 2008 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

St. Louis, Missouri
March 14, 2008

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES
Consolidated Balance Sheets
December 31, 2007 and 2006

	2007	2006
Assets		
Loans, net of allowance for loan losses of \$9,281,848 and \$9,015,378 at December 31, 2007 and 2006, respectively	\$ 901,996,263	803,297,381
Investment in available-for-sale securities, at fair value	151,742,455	183,566,135
Investment in equity securities, at cost	5,626,050	6,207,175
Federal funds sold and securities purchased under agreements to resell	664,184	9,922,961
Cash and due from banks	35,209,201	43,077,605
Premises and equipment	40,543,546	34,706,857
Other real estate owned and repossessed assets	2,337,107	2,734,500
Accrued interest receivable	8,764,196	8,773,686
Mortgage servicing rights	1,184,868	1,350,375
Goodwill	40,323,775	40,323,775
Intangible assets	2,831,540	3,753,877
Cash surrender value — life insurance	1,820,532	1,750,420
Other assets	2,760,362	3,247,150
Total assets	<u>\$1,195,804,079</u>	<u>1,142,711,897</u>
Liabilities and Stockholders' Equity		
Deposits:		
Demand	\$ 138,355,520	138,885,883
NOW	116,635,508	108,886,884
Savings	43,183,790	48,249,204
Money market	169,402,365	151,737,295
Time deposits \$100,000 and over	139,742,676	135,886,042
Other time deposits	313,937,432	316,219,426
Total deposits	<u>921,257,291</u>	<u>899,864,734</u>
Federal funds purchased and securities sold under agreements to repurchase	25,729,863	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	77,915,027	47,368,315
Accrued interest payable	4,723,965	4,366,250
Other liabilities	5,493,110	5,485,878
Total liabilities	<u>1,084,605,256</u>	<u>1,037,767,307</u>
Commitments and contingent liabilities		
Stockholders' equity:		
Common stock, \$1 par value. Authorized 15,000,000 shares; issued 4,298,353 shares	4,298,353	4,298,353
Surplus	22,530,191	22,248,319
Retained earnings	85,728,114	81,431,713
Accumulated other comprehensive income (loss), net of tax	1,356,538	(381,286)
Treasury stock; 128,858 and 128,506 shares, at cost	(2,714,373)	(2,652,509)
Total stockholders' equity	<u>111,198,823</u>	<u>104,944,590</u>
Total liabilities and stockholders' equity	<u>\$1,195,804,079</u>	<u>1,142,711,897</u>

See accompanying notes to consolidated financial statements.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES
Consolidated Statements of Income
Years ended December 31, 2007, 2006, and 2005

	2007	2006	2005
Interest income:			
Interest and fees on loans	\$65,533,873	62,578,814	49,316,370
Interest on debt securities:			
Taxable	5,702,806	5,750,751	5,095,896
Nontaxable	1,986,171	1,935,987	1,645,247
Interest on federal funds sold and securities purchased under agreements to resell	614,571	748,419	1,018,459
Interest on interest-bearing deposits	57,963	100,171	38,973
Dividends on equity securities	311,723	309,150	225,089
Total interest income	<u>74,207,107</u>	<u>71,423,292</u>	<u>57,340,034</u>
Interest expense:			
NOW accounts	1,482,373	1,390,264	1,665,813
Savings accounts	260,412	298,216	319,247
Money market accounts	5,668,258	5,186,055	3,618,277
Time deposit accounts \$100,000 and over	7,045,209	5,251,329	3,330,402
Other time deposit accounts	14,825,176	12,465,782	8,740,619
Securities sold under agreements to repurchase	1,133,688	1,754,974	1,237,899
Interest-bearing demand notes to U.S. Treasury	10,734	30,785	19,950
Federal funds purchased	246,640	55,693	18,309
Subordinated notes	3,617,254	3,528,418	2,747,293
Other borrowed money	2,885,119	2,804,892	1,975,781
Total interest expense	<u>37,174,863</u>	<u>32,766,408</u>	<u>23,673,590</u>
Net interest income	37,032,244	38,656,884	33,666,444
Provision for loan losses	1,154,216	1,325,733	1,321,612
Net interest income after provision for loan losses	<u>35,878,028</u>	<u>37,331,151</u>	<u>32,344,832</u>
Noninterest income:			
Service charges on deposit accounts	5,394,493	5,729,972	4,244,962
Trust department income	967,774	798,832	809,998
Mortgage loan servicing fees, net	341,377	432,517	427,127
Gain on sale of mortgage loans, net	665,817	432,112	676,666
Loss on sales of debt securities	(1,747)	(18,351)	(25,416)
Other	2,853,280	1,224,982	1,131,959
Total noninterest income	<u>10,220,994</u>	<u>8,600,064</u>	<u>7,265,296</u>
Noninterest expense:			
Salaries and employee benefits	18,733,125	17,019,086	13,920,030
Occupancy expense, net	2,201,809	1,994,592	1,600,424
Furniture and equipment expense	2,878,810	2,300,872	2,150,231
Legal, examination, and professional fees	1,582,763	1,431,354	1,419,614
Advertising and promotion	1,196,216	896,686	819,376
Postage, printing, and supplies	1,296,518	1,146,896	975,768
Impairment and other real-estate owned expense	680,832	119,171	136,694
Processing expense	1,470,475	1,008,673	750,791
Amortization of intangible assets	922,337	1,032,583	806,896
Other	4,090,922	3,198,230	2,788,326
Total noninterest expense	<u>35,053,807</u>	<u>30,148,143</u>	<u>25,368,150</u>
Income before income taxes	11,045,215	15,783,072	14,241,978
Income taxes	3,245,239	4,907,867	4,326,700
Net income	<u>\$ 7,799,976</u>	<u>10,875,205</u>	<u>9,915,278</u>
Basic earnings per share	\$ 1.87	2.61	2.38
Diluted earnings per share	1.85	2.59	2.36

See accompanying notes to consolidated financial statements.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity and Comprehensive Income
Years ended December 31, 2007, 2006 and 2005

	Common Stock	Surplus	Retained Earnings	Accumulated other Comprehensive Income (loss)	Treasury Stock	Total Stock - holders' Equity
Balance, December 31, 2004	\$4,298,353	22,014,894	67,716,511	393,534	(2,652,509)	91,770,783
Comprehensive income:						
Net income	—	—	9,915,278	—	—	9,915,278
Other comprehensive loss:						
Unrealized gain (loss) on securities:						
Unrealized loss on debt and equity securities available-for-sale, net of tax	—	—	—	(1,482,224)	—	(1,482,224)
Adjustment for loss on sales and calls of debt and equity securities, net of tax	—	—	—	16,520	—	16,520
Total other comprehensive loss						(1,465,704)
Total comprehensive income						8,449,574
Adjustment for deferred compensation plan	—	15,180	—	—	—	15,180
Cash dividends declared, \$0.84 per share	—	—	(3,502,672)	—	—	(3,502,672)
Balance, December 31, 2005	4,298,353	22,030,074	74,129,117	(1,072,170)	(2,652,509)	96,732,865
Comprehensive income:						
Net income	—	—	10,875,205	—	—	10,875,205
Other comprehensive loss:						
Unrealized gain (loss) on securities:						
Unrealized gain on debt and equity securities available-for-sale, net of tax	—	—	—	392,712	—	392,712
Adjustment for loss on sales and calls of debt and equity securities, net of tax	—	—	—	11,928	—	11,928
Total other comprehensive income						404,640
Total comprehensive income						11,279,845
Stock based compensation expense	—	218,245	—	—	—	218,245
Adjustment to initially apply SFAS No. 158, net of tax	—	—	(69,937)	286,244	—	216,307
Cash dividends declared, \$0.84 per share	—	—	(3,502,672)	—	—	(3,502,672)
Balance, December 31, 2006	4,298,353	22,248,319	81,431,713	(381,286)	(2,652,509)	104,944,590
Comprehensive income:						
Net income	—	—	7,799,976	—	—	7,799,976
Other comprehensive loss:						
Unrealized gain (loss) on securities:						
Unrealized gain on debt and equity securities available-for-sale, net of tax	—	—	—	1,403,925	—	1,403,925
Adjustment for loss on sales and calls of debt and equity securities, net of tax	—	—	—	1,136	—	1,136
Defined benefit pension plans:						
Prior service cost arising during period from plan amendment, net of tax	—	—	—	61,701	—	61,701
Net gain arising during period, net of tax	—	—	—	234,562	—	234,562
Amortization of prior service cost included in net periodic pension cost, net of tax	—	—	—	36,500	—	36,500

Total other comprehensive income						1,737,824
Total comprehensive income						<u>9,537,800</u>
Stock based compensation expense	—	264,881	—	—	—	264,881
Exercise of stock options	—	16,991	—	—	83,436	100,427
Treasury stock purchased	—	—	—	—	(145,300)	(145,300)
Cash dividends declared, \$0.84 per share	—	—	(3,503,575)	—	—	(3,503,575)
Balance, December 31, 2007	<u>\$4,298,353</u>	<u>22,530,191</u>	<u>85,728,114</u>	<u>1,356,538</u>	<u>(2,714,373)</u>	<u>111,198,823</u>

See accompanying notes to consolidated financial statements.

HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES
Consolidated Statements of Cash Flows
Years ended December 31, 2007, 2006, and 2005

	2007	2006	2005
Cash flows from operating activities:			
Net income	\$ 7,799,976	10,875,205	9,915,278
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	1,154,216	1,325,733	1,321,612
Depreciation expense	2,050,122	1,910,070	1,780,696
Net amortization (accretion) of debt securities, premiums, and discounts	(46,306)	(13,488)	1,665,189
Amortization of intangible assets	922,337	1,032,583	806,896
Stock based compensation expense	264,881	218,245	—
(Increase) decrease in accrued interest receivable	9,490	(1,001,113)	(1,234,671)
Increase in cash surrender value -life insurance	(70,112)	(67,584)	(71,798)
(Increase) decrease in other assets	(749,866)	(199,226)	714,907
Increase in accrued interest payable	357,715	1,227,120	1,131,714
Increase in other liabilities	7,232	472,775	1,927,354
Loss on sales of debt securities	1,747	18,351	25,416
Origination of mortgage loans for sale	(39,575,067)	(20,457,303)	(38,767,565)
Proceeds from the sale of mortgage loans	40,240,884	20,889,415	39,444,231
Gain on sale of mortgage loans, net	(665,817)	(432,112)	(676,666)
Loss (gain) on sales and dispositions of premises and equipment	323,752	31,033	(60,068)
Other, net	1,362,354	807,639	(1,030,849)
Net cash provided by operating activities	13,387,538	16,637,343	16,891,676
Cash flows from investing activities:			
Net increase in loans	(103,830,110)	(2,205,010)	(49,456,777)
Purchase of available-for-sale debt securities	(65,747,670)	(146,710,971)	(504,908,407)
Proceeds from maturities of available-for-sale debt securities	66,572,206	129,177,143	494,396,760
Proceeds from calls of available-for-sale debt securities	26,288,700	5,985,038	21,482,500
Proceeds from sales of available-for-sale debt securities	6,910,634	1,985,257	3,199,925
Purchase of equity securities	(2,015,900)	(1,008,150)	—
Proceeds from sales of equity securities	2,597,025	1,103,700	—
Acquisition of subsidiary, net of cash and cash equivalents acquired	—	—	(21,800,539)
Purchases of premises and equipment	(8,948,850)	(3,931,811)	(6,387,156)
Proceeds from sales of premises and equipment	738,287	174,759	171,304
Proceeds from sales of other real estate owned and repossessions	3,996,405	865,151	1,853,174
Net cash used in investing activities	(73,439,273)	(14,564,894)	(61,449,216)
Cash flows from financing activities:			
Net increase (decrease) in demand deposits	(530,363)	4,521,095	11,948,224
Net increase (decrease) in interest-bearing transaction accounts	20,348,280	(14,949,968)	(11,603,004)
Net increase in time deposits	1,574,640	28,838,401	4,849,825
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	(3,730,629)	(7,535,243)	1,474,489
Net increase (decrease) in interest-bearing demand notes to U.S. Treasury	(1,735,638)	637,301	179,898
Proceeds from Federal Home Loan Bank advances	137,000,000	176,624,684	14,500,000
Repayment of Federal Home Loan Bank advances	(106,453,288)	(181,436,030)	(15,104,177)
Proceeds from issuance of subordinated notes	—	—	23,712,000
Proceeds from sale of treasury stock	100,427	—	—
Purchase of treasury stock	(145,300)	—	—
Cash dividends paid	(3,503,575)	(3,502,672)	(3,377,576)
Net cash provided by financing activities	42,924,554	3,197,568	26,579,679
Net increase (decrease) in cash and cash equivalents	(17,127,181)	5,270,017	(17,977,861)
Cash and cash equivalents, beginning of year	53,000,566	47,730,549	65,708,410
Cash and cash equivalents, end of year	\$ 35,873,385	53,000,566	47,730,549
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	\$ 36,817,148	31,524,523	22,541,876
Income taxes	3,507,000	5,033,881	3,645,000
Supplemental schedule of noncash investing and financing activities:			
Other real estate and repossessions acquired in settlement of loans	\$ 3,977,012	2,031,998	3,348,616
Acquisition of Bank 10:			
Increase in loans	—	—	130,522,517
Increase in deposits	—	—	149,610,685

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to Consolidated Financial Statements

December 31, 2007, 2006 and 2005

(1) Summary of Significant Accounting Policies

Hawthorn Bancshares, Inc. (the Company) provides a full range of banking services to individual and corporate customers located within the communities surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee's Summit, Missouri. The Company is subject to competition from other financial and nonfinancial institutions providing financial products. Additionally, the Company and its subsidiaries are subject to the regulations of certain regulatory agencies and undergo periodic examinations by those regulatory agencies.

The consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles and conform to predominant practices within the banking industry. The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions, including the determination of the allowance for loan losses, real estate acquired in connection with foreclosure or in satisfaction of loans, and fair values of investment securities available-for-sale that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The significant accounting policies used by the Company in the preparation of the consolidated financial statements are summarized below:

Principles of Consolidation

As further described in note 17, during 2007 the Company combined its banking subsidiaries into Hawthorn Bank (the Bank), a wholly owned subsidiary. The consolidated financial statements include the accounts of the Company and the Bank. All significant intercompany accounts and transactions have been eliminated in consolidation.

Segment information

Prior to 2007, the Company defined its business segments to be each of its bank subsidiaries (Exchange National Bank, Citizens Union State Bank, Osage Valley Bank, and Bank 10). During 2007, the combination of the subsidiary banks into one bank resulted in the consolidation of the Company's business segments into a single business segment.

Loans

Loans are stated at unpaid principal balance amount less unearned income and the allowance for loan losses. Income on loans is accrued on a simple-interest basis.

Loans are placed on nonaccrual status when management believes that the borrower's financial condition, after consideration of business conditions and collection efforts, is such that collection of interest is doubtful. Subsequent interest payments received on such loans are applied to principal if doubt exists as to the collectibility of such principal; otherwise, such receipts are recorded as interest income. 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.

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**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to Consolidated Financial Statements

December 31, 2007, 2006 and 2005

Loan origination fees and certain direct costs are deferred and recognized over the life of the loan as an adjustment to yield.

The Bank originates certain loans which are sold in the secondary mortgage market. These long-term, fixed-rate loans are sold on a note-by-note basis. Immediately upon locking in an interest rate, the Company enters into an agreement to sell the mortgage loan without recourse, thereby eliminating the Company's exposure to interest rate fluctuations. At December 31, 2007 and 2006, \$1,832,000 and \$706,000 mortgage loans were held for sale, respectively. Mortgage loan servicing fees earned on loans sold are reported as income when the related loan payments are collected net of mortgage servicing right amortization. Operational costs to service such loans are charged to expense as incurred.

Allowance for Loan Losses

The allowance for loan losses is increased by provisions charged to expense and is reduced by loan charge-offs, net of recoveries. Management utilizes a systematic, documented approach in determining an adequate allowance for loan losses. Management's approach, which provides for general and specific valuation allowances, is based on current economic conditions, past losses, collection experience, risk characteristics of the portfolio, assessment of collateral values by obtaining independent appraisals for significant properties, and such other factors, which, in management's judgment, deserve current recognition in estimating loan losses.

Management believes the allowance for loan losses is adequate to absorb probable losses in the loan portfolio. While management uses available information to recognize loan losses, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the allowance for loan losses. Such agencies may require the Bank to increase the allowance for loan losses based on their judgment about information available to them at the time of their examination.

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. When measuring impairment, the expected future cash flows of an impaired loan are discounted at the loan's effective interest rate. Alternatively, impairment is measured by reference to an observable market price, if one exists, or the fair value of the collateral for a collateral-dependent loan. Regardless of the historical measurement method used, the Company measures impairment based on the fair value of the collateral when foreclosure is probable. Additionally, impairment of a restructured loan is measured by discounting the total expected future cash flows at the loan's effective rate of interest as stated in the original loan agreement. The Company follows its nonaccrual method for recognizing interest income on impaired loans.

Investment in Debt and Equity Securities

At the time of purchase, debt securities are classified into one of two categories: available-for-sale or held-to-maturity. Held-to-maturity securities are those securities which the Company has the ability and positive intent to hold until maturity. All debt securities not classified as held-to-maturity are classified as available-for-sale.

(Continued)

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to Consolidated Financial Statements

December 31, 2007, 2006 and 2005

Available-for-sale securities are recorded at fair value. Held-to-maturity securities are recorded at amortized cost, adjusted for the amortization of premiums or discounts. Unrealized gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and reported as accumulated other comprehensive income, a separate component of stockholders' equity, until realized.

Premiums and discounts are amortized using the interest method over the lives of the respective securities, with consideration of historical and estimated prepayment rates for mortgage-backed securities, as an adjustment to yield. Dividend and interest income are recognized when earned. Realized gains and losses for securities classified as available-for-sale are included in earnings based on the specific identification method for determining the cost of securities sold.

A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed other than temporary results in a charge to earnings and the establishment of a new cost basis for the security. To determine whether an impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year-end, and forecasted performance of the investee.

The Bank, as a member of the Federal Home Loan Bank System administered by the Federal Housing Finance Board, is required to maintain an investment in the capital stock of the Federal Home Loan Bank of Des Moines (FHLB) in an amount equal to 12 basis points of the bank's year-end total assets plus 4.45% of advances from the FHLB to the bank. These investments are recorded at cost, which represents redemption value.

Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation. Depreciation applicable to buildings and improvements and furniture and equipment is charged to expense using straight-line and accelerated methods over the estimated useful lives of the assets. Such lives are estimated to be 5 to 40 years for buildings and improvements and 3 to 15 years for furniture and equipment. Maintenance and repairs are charged to expense as incurred.

Goodwill and Other Intangible Assets

Goodwill represents the excess of costs over fair value of net assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives.

(Continued)

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

Notes to Consolidated Financial Statements

December 31, 2007, 2006 and 2005

The Company performs an annual review of goodwill and intangible assets for impairment to determine whether the carrying value of underlying assets may not be recoverable. The Company measures recoverability based upon the future cash flows expected to result from the use of the underlying asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying value of the underlying asset, the Company recognizes an impairment loss. The impairment loss recognized represents the amount by which the carrying value of the underlying asset exceeds the fair value of the underlying asset. As such adjustments become necessary, they are reflected in the results of operations in the periods in which they become known.

The core deposit intangible assets established in connection with prior acquisitions are being amortized over periods ranging from seven to ten years using straight-line and accelerated methods of amortization. Other intangible assets are amortized over periods up to seven years.

Impairment of Long-lived Assets

Long-lived assets, such as premises and equipment, and other intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Other Real Estate

Other real estate, included in other assets in the accompanying consolidated balance sheets, is recorded at fair value, less estimated selling costs. If the fair value of other real estate declines subsequent to foreclosure, the difference is recorded as a valuation allowance through a charge to expense. Subsequent increases in fair value are recorded through a reversal of the valuation allowance. Expenses incurred in maintaining the properties are charged to expense.

(Continued)

**HAWTHORN BANCSHARES, INC.
AND SUBSIDIARIES**

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Pension Plan

The Company has a noncontributory defined benefit pension plan covering all of its employees upon their retirement. The benefits are based on age, years of service and the level of compensation during the employees highest ten years of compensation before retirement. Net periodic costs are recognized as employees render the services necessary to earn the retirement benefits. The Company records annual amounts relating to its pension plan based on calculations that incorporate various actuarial and other assumptions including discount rates, mortality, assumed rates of return, compensation increases and turnover rates. The Company reviews its assumptions on an annual basis and may make modifications to the assumptions based on current rates and trends when it is appropriate to do so. The Company believes that the assumptions utilized in recording its obligations under its plan are reasonable based on its experience and market conditions.

Effective December 31, 2006, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* — an amendment of Financial Accounting Standards Board (FASB) Statements No. 87, 88, 106, and 132(R) (SFAS No. 158). SFAS No. 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its consolidated balance sheet and to recognize changes in the funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This statement also requires an employer to measure the funded status of a plan as of the date of its fiscal year-end, with limited exceptions.

Income Taxes

The Company estimates income tax expense based on amounts expected to be owed to various tax jurisdictions. Accrued taxes represent the net estimated amount due or to be received from taxing jurisdictions either currently or in the future and are reported in other assets or other liabilities on the consolidated balance sheet. In estimating accrued taxes, the Company assesses the relative merits and risks of the appropriate tax treatment considering statutory, judicial and regulatory guidance in the context of the tax position. Because of the complexity of tax laws and regulations, interpretation can be difficult and subject to legal judgment given specific facts and circumstances. It is possible that others, given the same information, may at any point in time reach different reasonable conclusions regarding the estimated amounts of accrued taxes.

Changes in the estimate of accrued taxes occur periodically due to changes in tax rates, interpretations of tax laws, the status of examinations being conducted by various taxing authorities, and newly enacted statutory, judicial and regulatory guidance that impact the relative merits and risks of tax positions. These changes, when they occur, affect accrued taxes and can be significant to the operating results of the Company. 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 applies to the fact of each matter. The Company's state and federal income tax returns for 2004 to 2007 are open tax years. As of December 31, 2007, there were no federal or state income tax examinations in process.

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**HAWTHORN BANCSHARES, INC.
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Notes to Consolidated Financial Statements

December 31, 2007, 2006 and 2005

Effective January 1, 2007, the Company adopted FASB 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 must recognize, in its financial statements, the best estimate of the impact of a tax position 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, FIN 48 requires 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 (a) reductions in deferred tax assets or increases in deferred tax liabilities or (b) increases in a liability for income taxes payable or reduction of an income tax refund receivable. See note 14 for additional income tax information.

Trust Department

Property held by the Bank in fiduciary or agency capacity for customers is not included in the accompanying consolidated balance sheets, since such items are not assets of the Company. Trust department income is recognized on the accrual basis.

Earnings per Share

Earnings per share is computed as follows:

	2007	2006	2005
Net income, basic and diluted	\$7,799,976	10,875,205	9,915,278
Average shares outstanding	4,171,163	4,169,847	4,169,847
Effect of dilutive stock options	39,681	34,700	29,012
Average shares outstanding including dilutive stock options	\$4,210,844	4,204,547	4,198,859
Net income per share, basic	\$ 1.87	2.61	2.38
Net income per share, diluted	1.85	2.59	2.36

Stock options that have a strike price greater than the current market price are considered anti-dilutive. For the years ended December 31, 2007, 2006, and 2005, 6,082, 4,482, and 6,149 shares of stock, respectively, are excluded in the calculation because their effect would be anti-dilutive.

Consolidated Statements of Cash Flows

For the purpose of the consolidated statements of cash flows, cash and cash equivalents consist of federal funds sold and securities sold or purchased under agreements to resell, cash, and due from banks.

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**HAWTHORN BANCSHARES, INC.
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Stock Options

The Company maintains a stock-based incentive program. Prior to 2006, the Company applied the intrinsic value-based method, as outlined in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB No. 25) and related interpretations, in accounting for stock options granted under these programs. Under the intrinsic value-based method, no compensation expense was recognized if the exercise price of the Company's employee stock options equaled the market price of the underlying stock on the date of the grant. Accordingly, prior to 2006, no compensation cost was recognized in the consolidated statements of income for stock options granted to employees, since all options granted under the company's share incentive programs had an exercise price equal to the fair value of the underlying common stock on the date of the grant.

Effective January 1, 2006, the Company adopted SFAS No. 123(R) *Share-Based Payment*. This statement replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB No. 25. SFAS No. 123(R) requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. This statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation expense on a prospective basis. Therefore, prior period financial statements have not been restated. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro forma disclosures in prior periods. SFAS No. 123(R) also requires that excess tax benefits related to stock option exercises be reflected as financing cash inflows instead of operating cash inflows.

The following table illustrates the effect on net income and earnings per share if the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, had been applied to all outstanding and unvested awards in the prior period ended December 31, 2005:

Net income:	
As reported	\$9,915,278
Deduct total stock-based employee compensation expense determined under fair-value based method for all awards, net of tax	(142,799)
Pro forma	<u>\$9,772,479</u>
Pro forma earnings per common share:	
As reported basic	\$ 2.38
Pro forma basic	2.34
As reported diluted	2.36
Pro forma diluted	2.33

(Continued)

**HAWTHORN BANCSHARES, INC.
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Notes to Consolidated Financial Statements

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Treasury Stock

The purchase of the Company's common stock is recorded at cost. Upon subsequent reissuance, the treasury stock account is reduced by the average cost basis of such stock.

Comprehensive Income

The Company reports comprehensive income in the consolidated statements of stockholders' equity and comprehensive income (loss).

Recently Issued Accounting Standards

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

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 gives the Company the irrevocable option to carry most financial assets and liabilities at fair value that are not currently required to be measured at fair value. If the fair value option is elected, changes in fair value would be recorded in earnings at each subsequent reporting date. SFAS 159 is effective for the Company's 2008 fiscal year. The Company is currently evaluating the impact the adoption of this statement could have on its financial condition, and results of operations. However, it is not expected to have a material impact on the Company's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement*. SFAS No.157 defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The statement does not require any new fair value measures. The statement is effective for fair value measures already required or permitted by other standards for fiscal years beginning after November 15, 2007. The Company is required to adopt SFAS 157 beginning on January 1, 2008. SFAS 157 is required to be applied prospectively, except for certain financial instruments. Any transition adjustment will be recognized as an adjustment to opening retained earnings in the year of adoption. In November 2007, the FASB proposed a one-year deferral of SFAS No.157's fair-value measurement requirements for nonfinancial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. The Company is currently evaluating the impact of adopting SFAS No.157 on its results of operations and financial position.

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However, it is not expected to have a material impact on the Company's financial position or results of operations.

In September 2006, the FASB's Emerging Issues Task Force reached a consensus on Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* (EITF 06-4). EITF 06-4 provides guidance on the accounting for arrangements in which an employer owns and controls the insurance policy and has agreed to share a portion of the cash surrender value and/or death benefit with the employee. This guidance requires an employer to record a postretirement benefit, in accordance with FASB Statement No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions* or APB Opinion No. 12, *Omnibus Opinion-1967*, if there is an agreement by the employer to share a portion of the proceeds of a life insurance policy with the employee during the postretirement period. This guidance is effective for reporting periods beginning after December 15, 2007. The Company is currently evaluating the impact of adopting EITF 06-4 on its financial position and results of operations. However, it is not expected to have a material impact on the financial position or results of operations.

Effective January 1, 2007, the Company adopted 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 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. The Company is using the amortized cost method of accounting for servicing assets. The adoption had no material impact on the Company's financial position or results of operations.

Reclassifications

Certain prior year information has been reclassified to conform to the current year presentation.

(2) Acquisitions

On May 2, 2005 the Company acquired 100% of the outstanding common shares of Bank 10 from Drexel Bancshares, Inc. of Belton, Missouri. Accordingly, the results of operations of Bank 10 have been included in the condensed consolidated financial statements since the date of acquisition. Bank 10 has branches in Belton, Drexel, Independence, Harrisonville, and Raymore, Missouri.

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A summary of unaudited pro forma combined financial information for the year ended December 31, 2005 for the Company and Bank 10 as if the transaction had occurred on January 1, 2005 follows:

	December 31, 2005
Net interest income	\$35,399,301
Net income	10,109,876
Basic earnings per share	\$ 2.42
Diluted earnings per share	\$ 2.41

(3) Capital Requirements

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

Quantitative measures established by regulations to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital to risk-weighted assets, and of Tier I capital to adjusted-average assets. Management believes, as of December 31, 2007 and 2006, the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2007, the most recent notification from the regulatory authorities categorized the bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since the notifications that management believes have changed the Bank's categories.

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The actual and required capital amounts and ratios for the Company and the Bank as of December 31, 2007 and 2006 are as follows (dollars in thousands):

2007						
	Actual		Capital requirements		To be well capitalized under prompt corrective action provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets):						
Company	\$123,970	13.24%	\$74,925	8.00%	—	—%
Hawthorn Bank	115,395	12.35	74,740	8.00	93,425	10.00
Tier I capital (to risk-weighted assets):						
Company	103,754	11.08	37,463	4.00	—	—
Hawthorn Bank	106,113	11.36	37,370	4.00	56,055	6.00
Tier I capital (to adjusted average assets):						
Company	103,754	9.12	34,148	3.00	—	—
Hawthorn Bank	106,113	9.33	34,126	3.00	56,876	5.00
2006						
	Actual		Capital requirements		To be well capitalized under prompt corrective action provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets):						
Company	\$118,184	13.84%	\$68,293	8.00%	—	—%
Hawthorn Bank	110,316	12.93	68,234	8.00	85,292	10.00
Tier I capital (to risk-weighted assets):						
Company	96,300	11.28	34,147	4.00	—	—
Hawthorn Bank	101,451	11.89	34,117	4.00	51,175	6.00
Tier I capital (to adjusted average assets):						
Company	96,300	8.77	32,937	3.00	—	—
Hawthorn Bank	101,451	9.25	32,892	3.00	54,820	5.00

Bank dividends are the principal source of funds for payment of dividends by the Company to its stockholders. The Bank is subject to regulations which require the maintenance of minimum capital requirements. At December 31, 2007, unappropriated retained earnings of approximately \$25,079,000 were available for the declaration of dividends to the Company without prior approval from regulatory authorities.

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(4) Loans

A summary of loans, by classification, at December 31, 2007 and 2006 is as follows:

	2007	2006
Commercial	\$151,487,677	145,696,898
Real estate — construction	147,432,123	150,890,994
Real estate — mortgage	575,551,891	478,852,928
Installment and other consumer	36,738,062	36,967,543
Unamortized loan origination fees and costs, net	68,358	(95,604)
	<u>911,278,111</u>	<u>812,312,759</u>
Less allowance for loan losses	9,281,848	9,015,378
	<u>\$901,996,263</u>	<u>803,297,381</u>

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the communities surrounding Jefferson City, Clinton, Warsaw, Springfield, Branson and Lee's Summit, Missouri. As such, the Bank is susceptible to changes in the economic environment in these communities. The Bank does not have a concentration of credit in any one economic sector. Installment and other consumer loans consist primarily of the financing of vehicles.

Following is a summary of activity in 2007 of loans made by the Bank to executive officers and directors or to entities in which such individuals had a beneficial interest. Such loans were made in the normal course of business on substantially the same terms, including interest rates and collateral requirements, as those prevailing at the same time for comparable transactions with other persons, and did not involve more than the normal risk of collectibility or present unfavorable features.

Balance at December 31, 2006	\$15,557,446
New loans	1,295,380
Transfers of officers and directors out of executive category	(8,225,519)
Payments received	(2,150,993)
Balance at December 31, 2007	<u>\$ 6,476,314</u>

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Changes in the allowance for loan losses for 2007, 2006 and 2005 are as follows:

	2007	2006	2005
Balance, beginning of year	\$ 9,015,378	9,084,774	7,495,594
Allowance for loan losses of acquired subsidiary at date of acquisition	—	—	1,418,084
Provision for loan losses	1,154,216	1,325,733	1,321,612
Charge-offs	(1,307,644)	(1,850,904)	(1,321,154)
Recoveries of loans previously charged off	419,898	455,775	170,638
Balance, end of year	<u>\$ 9,281,848</u>	<u>9,015,378</u>	<u>9,084,774</u>

A summary of nonaccrual and other impaired loans at December 31, 2007 and 2006 is as follows:

	2007	2006
Nonaccrual loans	\$4,538,364	4,868,190
Impaired loans continuing to accrue interest	4,026,976	9,187,402
Total impaired loans	<u>\$8,565,340</u>	<u>14,055,592</u>
Allowance for loan losses on impaired loans	\$3,256,342	3,287,231
Impaired loans with no specific allowance for loan losses	500,236	3,117,489
Loans past due 90 days or more continuing to accrue interest	\$1,545,030	197,271

The average balance of impaired loans during 2007 and 2006 was \$8,915,000 and \$12,219,000, respectively.

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A summary of interest income on nonaccrual and other impaired loans for 2007, 2006, and 2005 is as follows:

	Nonaccrual loans	Impaired loans continuing to accrue interest	Total
2007:			
Income recognized	\$329,566	359,229	688,795
Interest income had interest accrued	744,675	359,229	1,103,904
2006:			
Income recognized	62,793	578,766	641,559
Interest income had interest accrued	896,102	578,766	1,474,868
2005:			
Income recognized	252,901	136,467	389,368
Interest income had interest accrued	766,693	136,467	903,160

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(5) Investment in Debt and Equity Securities

The amortized cost and fair value of debt securities classified as available-for-sale at December 31, 2007 and 2006 are as follows:

	2007			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Government sponsored enterprises	\$ 86,862,693	583,028	75,323	87,370,398
Asset-backed securities	10,861,809	50,869	20,442	10,892,236
Obligations of states and political subdivisions	52,883,289	646,153	49,621	53,479,821
Total available for sale securities	<u>\$150,607,791</u>	<u>1,280,050</u>	<u>145,386</u>	<u>151,742,455</u>

	2006			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
U.S. treasuries	\$ 1,070,110	—	2,090	1,068,020
Government sponsored enterprises	122,692,450	86,038	1,009,597	121,768,891
Asset-backed securities	5,163,716	3,410	98,845	5,068,281
Obligations of states and political subdivisions	55,660,825	346,948	346,830	55,660,943
Total available for sale securities	<u>\$184,587,101</u>	<u>436,396</u>	<u>1,457,362</u>	<u>183,566,135</u>

Equity securities recorded at cost consist primarily of Federal Home Loan Bank Stock, Federal Reserve Stock, and the Company's interest in the statutory trusts described in note 11.

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The amortized cost and fair value of debt securities classified as available-for-sale at December 31, 2007, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without prepayment penalties.

	Amortized cost	Fair value
Due in one year or less	\$ 41,254,866	41,237,300
Due after one year through five years	59,679,247	60,342,540
Due after five years through ten years	27,848,726	28,190,781
Due after ten years	10,963,143	11,079,598
	<u>139,745,982</u>	<u>140,850,219</u>
Asset-backed securities	10,861,809	10,892,236
	<u>\$150,607,791</u>	<u>151,742,455</u>

Debt securities with carrying values aggregating approximately \$110,551,000 and \$109,492,000 at December 31, 2007 and 2006, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

Proceeds of \$6,910,634 and gross losses of \$1,747 were recorded on the sales of debt securities in 2007. Proceeds of \$1,985,257 and gross losses of \$18,351 were recorded on the sales of debt securities in 2006. Proceeds of \$3,199,925 and gross losses of \$25,416 were recorded on the sales of debt securities in 2005.

Gross unrealized losses on debt securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2007, were as follows:

	Less than 12 months		12 months or more		Number of Investment Positions	Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses		Fair Value	Unrealized Losses
Government sponsored enterprises	\$ —	—	23,772,426	(75,323)	21	23,772,426	(75,323)
Asset-backed securities	109,678	(313)	1,815,773	(20,129)	20	1,925,451	(20,442)
Obligations of states and political subdivisions	1,640,819	(18,247)	13,393,396	(31,373)	49	15,034,215	(49,620)
	<u>\$1,750,497</u>	<u>(18,560)</u>	<u>38,981,595</u>	<u>(126,825)</u>	<u>90</u>	<u>40,732,092</u>	<u>(145,385)</u>

Government sponsored enterprises: The unrealized losses on investments in government sponsored enterprises were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company has the ability and intent to hold these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

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Asset-backed securities: The unrealized losses on asset-backed securities were caused by interest rate increases. The contractual cash flows of these securities are guaranteed by various government or government sponsored enterprises. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

Obligations of states and political subdivisions: The unrealized losses on investments in obligations of states and political subdivisions were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company has the ability and intent to hold these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

(6) Premises and Equipment

A summary of premises and equipment at December 31, 2007 and 2006 is as follows:

	2007	2006
Land and land improvements	\$10,155,282	9,696,480
Buildings and improvements	31,190,973	24,229,498
Furniture and equipment	11,241,357	12,370,088
Construction in progress	166,318	2,024,514
	<u>52,753,930</u>	<u>48,320,580</u>
Less accumulated depreciation	12,210,384	13,613,723
	<u>\$40,543,546</u>	<u>34,706,857</u>

Depreciation expense for the past three years is as follows:

	Year ended December 31,		
	2007	2006	2005
Depreciation expense	\$2,050,122	1,910,070	1,780,696

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(7) Goodwill and Other Intangible Assets

A summary of goodwill and other intangible assets at December 31, 2007 and 2006 is as follows:

	<u>2007</u>	<u>2006</u>
Goodwill	\$40,323,775	40,323,775
Core deposit intangible	2,831,540	3,753,877
	<u>\$43,155,315</u>	<u>44,077,652</u>

The gross carrying amount and accumulated amortization of the Company's amortized intangible assets for the years ended December 31, 2007 and 2006 are as follows:

	Year ended December 31,			
	<u>2007</u>		<u>2006</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Amortized intangible assets:				
Core deposit intangible	\$7,060,224	(4,228,684)	7,060,224	(3,306,347)
	<u>\$7,060,224</u>	<u>(4,228,684)</u>	<u>7,060,224</u>	<u>(3,306,347)</u>

The aggregate amortization expense of intangible assets subject to amortization for the past three years is as follows:

	Year ended December 31,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Aggregate amortization expense	\$922,337	1,032,583	806,896

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

For the year ending:	
2008	\$701,443
2009	626,111
2010	526,477
2011	434,763
2012	408,062

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(8) Mortgage Servicing Rights

Mortgage loans serviced for others totaled approximately \$209,734,000 and \$215,700,000 at December 31, 2007 and 2006, respectively. Mortgage servicing rights totaled approximately \$1,185,000 and \$1,350,000 at December 31, 2007 and 2006, respectively.

Changes in the balance of servicing assets related to the loans serviced by Hawthorn Bank for the years ended December 31, 2007 and 2006 are as follows:

Balance at December 31, 2005	\$1,536,331
Additions	239,873
Amortization	(425,829)
Balance at December 31, 2006	1,350,375
Additions	285,273
Amortization	(450,780)
Balance at December 31, 2007	<u>\$1,184,868</u>

The Company's mortgage servicing rights are amortized in proportion to the related estimated net servicing income on a straight line basis over the estimated lives of the related mortgages which is seven years. The estimated amortization expense for the next five years is as follows:

For the year ending:	
2008	\$352,000
2009	266,000
2010	182,000
2011	149,000
2012	121,000

(9) Deposits

The scheduled maturities of time deposits are as follows (in thousands):

	<u>2007</u>	<u>2006</u>
Due within:		
One year	\$ 379,927	378,732
Two years	36,868	48,996
Three years	27,912	12,057
Four years	5,790	8,186
Five years	3,053	3,975
Thereafter	130	159
	<u>\$ 453,680</u>	<u>452,105</u>

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(10) Securities Sold Under Agreements to Repurchase

Information relating to securities sold under agreements to repurchase is as follows:

	2007	2006
Average daily balance	\$26,806,926	41,308,902
Maximum balance at month-end	28,704,922	56,027,169
Year end balance	18,364,863	27,320,492
Weighted average interest rate at year-end	3.24%	4.35%
Weighted average interest rate for the year	4.23%	4.25%

The securities underlying the agreements to repurchase are under the control of the Bank.

Under agreements with unaffiliated banks, the Bank may borrow up to \$75,000,000 in federal funds on an unsecured basis and \$8,000,000 on a secured basis at December 31, 2007. As of December 31, 2007 and 2006, the Bank had \$7,365,000 and \$2,140,000, respectively, in federal funds purchased.

(11) Subordinated Notes

On March 17, 2005, Exchange Statutory Trust II, a newly formed business trust issued \$23,000,000 of 30-year floating rate Trust Preferred Securities (TPS) to a TPS Pool. The interest rate on the TPS is a fixed rate at 6.30% for five years then converting to a floating rate. The floating rate will be based on a specific margin above three-month LIBOR. The TPS can be prepaid without penalty at any time after five years from the issuance date.

The TPS represent preferred interests in the trust. The Company invested approximately \$712,000 in common interests in the trust and the purchaser in the private placement purchased \$23,000,000 in preferred interests. The proceeds were used by the trust to purchase from the Company its 30-year deeply subordinated debentures whose terms mirror those stated above for the TPS. The debentures are guaranteed by the Company pursuant to a subordinated guarantee. Distributions on the TPS are payable quarterly on March 17, June 17, September 17, and December 17 of each year that the TPS are outstanding. The trustee for the TPS holders is U.S. Bank, N.A. The trustee does not have the power to take enforcement action in the event of a default under the TPS for five years from the date of default. In the event of default, however, the Company would be precluded from paying dividends until the default is cured.

The proceeds of the private placement TPS were used by the Company to facilitate the Bank 10 acquisition as described in note 2.

On March 17, 2004, Exchange Statutory Trust I, a newly formed Delaware business trust and subsidiary of the Company issued \$25,000,000 of floating TPS to a TPS Pool. The floating rate is equal to the three-month LIBOR rate plus 2.70% and reprices quarterly (7.96% at December 31, 2007). The TPS are fully, irrevocably, and unconditionally guaranteed on a subordinated basis by the Company. The proceeds of the TPS were invested in junior subordinated debentures of the Company. The net proceeds to the Company from the sale of the junior subordinated debentures, after deducting underwriting commissions and estimated offering expenses, were approximately \$25,000,000. Distributions on the TPS are payable quarterly on March 17, June 17, September 17, and December 17 of each year that the TPS are outstanding.

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The TPS mature on March 17, 2034. That maturity date may be shortened to a date not earlier than March 17, 2009 if certain conditions are met. A portion of the proceeds from the offering were used to repay \$11,000,000 of previously outstanding indebtedness with the remaining available for cash operating reserves at the holding company level.

The Exchange Statutory Trusts are not consolidated in the Company's financial statements. Accordingly, the Company does not report the securities issued by the Exchange Statutory Trusts as liabilities, and instead reports the subordinated notes issued by the Company and held by the Exchange Statutory Trusts as liabilities. The amount of the subordinated notes as of December 31, 2007 and 2006 were \$49,486,000 for both periods. The Company recorded the investments in the common securities issued by the Exchange Statutory Trusts and corresponding obligations of the subordinated notes, as well as interest income and interest expense on the investments and obligations.

(12) Other Borrowed Money

Other borrowed money at December 31, 2007 and 2006 is summarized as follows:

	<u>2007</u>	<u>2006</u>
Federal Home Loan Bank of Des Moines advances, weighted average rates of 4.86% and 4.92% at December 31, 2007 and 2006, respectively, due at various dates through 2013	<u>\$77,915,027</u>	<u>47,368,315</u>

The advances from the Federal Home Loan Bank of Des Moines are secured under a blanket agreement which assigns all investment in Federal Home Loan Bank of Des Moines stock, as well as mortgage loans equal to 125% to 175% (based on collateral type) of the outstanding advance balance, to secure amounts borrowed at the Bank. The Bank has \$12,000,000 and \$5,000,000 of FHLB advances callable on February 27, 2008 and March 3, 2008, respectively. Based upon the collateral pledged to the Federal Home Loan Bank of Des Moines at December 31, 2007, the Bank had a credit line of \$117,789,000, of which \$39,774,000 was available for additional borrowings.

The Company also has a \$20,000,000 line of credit with an unaffiliated bank secured by subsidiary stock. The interest rate charged on borrowings under the line is equal to the 30 day LIBOR plus 150 basis points and adjusts quarterly. The Company pays no fees on the unused portion of the line of credit. The line of credit was renewed in January 2008 and is now due December 2008. There was no outstanding balance on the line of credit at December 31, 2007 or 2006.

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The scheduled principal reduction of other borrowed money at December 31, 2007 is as follows:

2008	\$48,157,545
2009	12,733,762
2010	16,062,743
2011	575,989
2012	258,528
2013 and thereafter	126,460
	<u>\$77,915,027</u>

(13) Reserve Requirements and Compensating Balances

The Federal Reserve Bank required the Bank to maintain cash or balances of \$14,545,000 and \$6,595,000 at December 31, 2007 and 2006, respectively, to satisfy reserve requirements.

Average compensating balances held at correspondent banks were \$1,333,000 and \$3,248,000 at December 31, 2007 and 2006, respectively. The Bank maintains such compensating balances with correspondent banks to offset charges for services rendered by those banks.

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(14) Income Taxes

The composition of income tax expense (benefit) for 2007, 2006, and 2005 is as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Current:			
Federal	\$3,549,527	4,252,932	4,326,338
State	60,297	177,491	142,234
Total current	3,609,824	4,430,423	4,468,572
Deferred	(364,585)	477,444	(141,872)
Total income tax expense	<u>\$3,245,239</u>	<u>4,907,867</u>	<u>4,326,700</u>

Applicable income taxes for financial reporting purposes differ from the amount computed by applying the statutory Federal income tax rate for the reasons noted in the table below:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Tax at statutory Federal income tax rate	\$3,765,825	5,447,567	4,884,692
Tax-exempt income	(628,158)	(685,580)	(599,641)
State income tax, net of Federal tax benefit	39,796	115,369	92,452
Other, net	67,776	30,511	(50,803)
	<u>\$3,245,239</u>	<u>4,907,867</u>	<u>4,326,700</u>

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The components of deferred tax assets and deferred tax liabilities at December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Deferred tax assets:		
Allowance for loan losses	\$3,619,921	2,659,053
Nonaccrual loan interest	237,133	45,647
Core deposit intangible	560,243	302,703
Available-for-sale securities	—	353,437
Accrued pension expense	126,670	209,505
Deferred compensation	136,789	106,889
Other	400,843	281,763
Total deferred tax assets	<u>5,081,599</u>	<u>3,958,997</u>
Deferred tax liabilities:		
Premises and equipment	725,693	805,482
Mortgage servicing rights	111,849	93,849
FHLB stock dividend	102,921	92,365
Available-for-sale securities	443,228	—
Intangible assets	2,260,390	1,266,329
Other	507,668	119,531
Total deferred tax liabilities	<u>4,151,749</u>	<u>2,377,556</u>
Net deferred tax asset	<u>\$ 929,850</u>	<u>1,581,441</u>

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not the Company will realize the benefits of these temporary differences at December 31, 2007 and, therefore, has not established a valuation reserve.

At December 31, 2007, the accumulation of prior years' earnings representing tax bad debt deductions of the Bank was \$2,931,503. If these tax bad debt reserves were charged for losses other than bad debt losses, the Bank would be required to recognize taxable income in the amount of the charge. It is not contemplated that such tax-restricted retained earnings will be used in a manner that would create federal income tax liabilities.

Effective January 1, 2007, the Company adopted FIN 48. The interpretation defines the threshold for recognizing the financial impact of uncertain tax provisions in accordance with FAS 109. An enterprise must recognize, in its financial statements, the best estimate of the impact of a tax position 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.

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In evaluating whether the probable recognition threshold has been met, FIN 48 requires 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 (a) reductions in deferred tax assets or increases in deferred tax liabilities or (b) increases in a liability for income taxes payable or reduction of an income tax refund receivable. As of December 31, 2007, the Company had \$957,000 of gross unrecognized tax benefits of which \$645,000 would impact the effective tax rate, if recognized. The Company expects a reduction of \$208,000 in gross unrecognized tax benefits during 2008 as a result of the state statute of limitations closing for the 2004 tax year. The unrecognized tax benefits are related to various federal and state tax positions.

FIN 48 also provides guidance on disclosure, accrual of interest and penalties, accounting in interim periods, and transition. As of December 31, 2007, interest accrued was approximately \$104,000. The unrecognized tax benefits are as follows:

Unrecognized tax benefits as of January 1, 2007	\$1,015,361
Gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during prior years	(164,793)
Gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during 2007	340,351
Reductions to unrecognized benefits as a result of a lapse of the applicable statute of limitations	<u>(234,342)</u>
Unrecognized tax benefits as of December 31, 2007	<u>\$ 956,577</u>

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(15) Pension and Retirement Plans

The Company provides a noncontributory defined benefit pension plan for all full-time employees.

Pension expense for 2007, 2006, and 2005 is as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Service cost—benefits earned during the year	\$ 797,675	620,564	471,319
Interest costs on projected benefit obligations	364,406	318,142	276,245
Expected return on plan assets	(385,269)	(369,164)	(368,873)
Net amortization and deferral	—	—	(26,632)
Amortization of prior service cost	78,628	78,628	39,315
Amortization of net gains	(18,152)	(2,601)	—
Pension expense	<u>\$ 837,288</u>	<u>645,569</u>	<u>391,374</u>

As a result of adopting SFAS No. 158 on December 31, 2006, the measurement date used to determine pension benefit measures for the pension plan was changed to December 31. Prior to 2006, the measurement date was November 1.

A summary of the activity in the Plan's projected benefit obligation, assets, funded status, accumulated benefit obligation, and amounts recognized in the Company's consolidated balance sheets at December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Projected benefit obligation:		
Balance, January 1	\$6,855,269	6,184,323
Service cost	797,675	723,991
Interest cost	364,406	371,166
Actuarial gain	(451,125)	(120,800)
Benefits paid	(273,225)	(303,411)
Balance, December 31	<u>\$7,293,000</u>	<u>6,855,269</u>
Accumulated benefit obligation	<u>\$5,495,000</u>	<u>5,155,626</u>

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	2007	2006
Plan assets:		
Fair value, January 1	\$ 6,256,681	5,584,438
Actual return	389,932	975,654
Employer contribution	594,817	—
Benefits paid	(273,225)	(303,411)
Fair value, December 31	<u>\$ 6,968,205</u>	<u>6,256,681</u>
Funded status:		
Projected benefit obligation	\$(7,293,000)	(6,855,269)
Plan assets at fair value	<u>6,968,205</u>	<u>6,256,681</u>
Pension benefit liability	<u>\$ (324,795)</u>	<u>(598,588)</u>

Amounts recognized in accumulated other comprehensive income consist of:

	Pension benefits	
	2007	2006
Net actuarial gain	\$ (18,152)	(434)
Prior service costs	78,628	13,105
	<u>\$ 60,476</u>	<u>12,671</u>

The net actuarial gain and prior service cost for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit pension cost for 2008 are \$52,879 and \$78,628, respectively.

Assumptions utilized to determine benefit obligations as of December 31, 2007, 2006 and 2005 and to determine pension expense for the year then ended are as follows:

	2007	2006	2005
Benefit obligation:			
Discount rate	6.25%	5.50%	5.25%
Annual rate of compensation increase	4.50%	4.50%	5.00%
Pension expense:			
Discount rate for the service cost	5.50%	5.25%	5.25%
Annual rate of compensation increase	4.50%	5.00%	6.00%
Expected long-term rate of return on plan assets	7.00%	7.00%	7.00%

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The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories or plan assets. The approximate weighted-average asset allocation of the plan's assets at December 31, 2007 and 2006 were as follows: equity securities 79% and 83%, debt securities 14% and 13% and other assets 7% and 4%, respectively. The Company's investment goals are to invest the assets in a manner that they benefit both the current beneficiaries and the future beneficiaries of the pension plan, while minimizing the risk to the overall portfolio. The Company addresses these issues by diversifying the assets through investments in domestic and international fixed income securities and domestic and international equity securities. The assets are readily marketable and can be sold to fund benefit payment obligations as they become payable. The benefits expected to be paid in the years 2008 to 2012 are \$279,000, \$273,000, \$306,000, \$340,000, and \$353,000, respectively. The aggregate benefits expected to be paid in the five years from 2013 to 2017 are \$2,438,000.

Under the provisions of the Pension Protection Act of 2006 the Company may make a contribution to the defined benefit pension plan in 2008 up to \$1,000,000. The Company has not made a determination if it will make a contribution in 2008.

In addition to the pension plan described above, the Company provides a 401k profit-sharing plan which covers all full-time employees. The Company makes annual contributions in an amount up to 6% of income before income taxes and before contributions to the profit-sharing and pension plans for all participants, limited to the maximum amount deductible for Federal income tax purposes. In addition, employees may make additional tax-deferred contributions. Company contributions to the profit-sharing plan for 2007, 2006, and 2005 were \$758,778, \$1,051,140, and \$864,096, respectively. Beginning in 2008, the plan has been amended to a matching 401k plan in which the Company will match the first 3% of eligible employee contributions.

In 2005, Bank 10 of Belton had a 401k plan covering all eligible employees. Matching contributions by Bank 10 to the 401k plan for 2005 were \$98,490.

(16) Stock Compensation

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

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

	Number of shares December 31			Weighted average exercise price December 31		
	2007	2006	2005	2007	2006	2005
Outstanding, beginning of year	202,739	160,809	125,391	\$ 24.54	24.54	23.44
Granted	48,104	44,276	35,418	33.50	29.95	28.45
Exercised	(4,649)	—	—	20.13	—	—
Canceled	(3,226)	(2,346)	—	30.53	29.95	—
Outstanding, end of year	<u>242,968</u>	<u>202,739</u>	<u>160,809</u>	27.23	25.66	24.54
Exercisable, end of year	140,186	111,025	77,361	23.63	21.82	19.92

Options outstanding at December 31, 2007 had a remaining contractual life of approximately seven years and an intrinsic value of \$495,000.

Options outstanding at December 31, 2006 had a remaining contractual life of approximately seven years and an intrinsic value of \$1,280,000.

Options exercisable at December 31, 2007 had a weighted average remaining contractual life of approximately five years and an intrinsic value of approximately \$495,000. Options exercisable at December 31, 2006 had a weighted average remaining contractual life of approximately six years and an intrinsic value of approximately \$1,104,000. During 2007, 4,649 stock options were exercised. No stock options were exercised during 2006 or 2005.

Total stock-based compensation expense for the year ended December 31, 2007 and 2006 was \$265,000 (\$172,000 after tax) and \$218,000 (\$142,000 after tax), respectively. Prior to January 1, 2006, the Company applied APB Opinion No. 25 in accounting for the stock options and, accordingly, no compensation cost has been recognized in the consolidated financial statements for 2005. As of December 31, 2007, the total unrecognized compensation expense related to non-vested stock awards was \$501,000 and the related weighted average period over which it is expected to be recognized is approximately two years.

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

	2007	2006	2005
Options issued during:			
Grant date fair value per share	\$7.13	6.13	6.30
Significant assumptions:			
Risk-free interest rate at grant date	4.49%	4.61%	3.86%
Expected annual rate of quarterly dividends	2.50	2.80	2.30
Expected stock price volatility	20	20	22
Expected life to exercise (years)	6.25	6.25	6.25

(17) Condensed Financial Information of Parent Company Only

The condensed balance sheets as of December 31, 2007 and 2006 and the related condensed statements of income and cash flows for the years ended December 31, 2007, 2006 and 2005 of the Company are as follows:

Condensed Balance Sheets

	2007	2006
Assets		
Cash and due from bank subsidiaries	\$ 10,388,672	8,717,354
Investment in equity securities	1,486,000	1,486,000
Investment in subsidiaries	150,009,972	144,799,226
Premises and equipment	13,106	—
Deferred tax asset	—	408,391
Other assets	424,959	117,110
Total assets	<u>\$162,322,709</u>	<u>155,528,081</u>
Liabilities and Stockholders' Equity		
Subordinated notes	\$ 49,486,000	49,486,000
Deferred tax liability	96,214	—
Other liabilities	1,541,672	1,097,491
Stockholders' equity	<u>111,198,823</u>	<u>104,944,590</u>
Total liabilities and stockholders' equity	<u>\$162,322,709</u>	<u>155,528,081</u>

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Condensed Statements of Income

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Revenue:			
Interest and dividends received from subsidiaries	\$8,086,795	6,079,171	7,682,498
Other	1,308,622	105,954	141,141
Total revenue	<u>9,395,417</u>	<u>6,185,125</u>	<u>7,823,639</u>
Expenses:			
Interest on subordinated notes	3,617,254	3,528,418	2,747,293
Other	3,692,462	819,721	554,190
Total expenses	<u>7,309,716</u>	<u>4,348,139</u>	<u>3,301,483</u>
Income before income tax benefit and equity in undistributed income of subsidiaries	2,085,701	1,836,986	4,522,156
Income tax benefit	1,908,564	1,349,640	1,053,330
Equity in undistributed income of subsidiaries	<u>3,805,711</u>	<u>7,688,579</u>	<u>4,339,792</u>
Net income	<u><u>\$7,799,976</u></u>	<u><u>10,875,205</u></u>	<u><u>9,915,278</u></u>

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Condensed Statements of Cash Flows

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:			
Net income	\$ 7,799,976	10,875,205	9,915,278
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	3,276	—	—
Equity in undistributed income of subsidiaries	(3,805,711)	(7,688,579)	(4,339,792)
Stock based compensation expense	264,881	218,245	—
Other, net	973,726	22,750	97,372
Net cash provided by operating activities	<u>5,236,148</u>	<u>3,427,621</u>	<u>5,672,858</u>
Cash flows from investing activities:			
Purchase of premise and equipment	(16,382)	—	—
Acquisition of subsidiary, net of cash acquired	—	—	(34,020,004)
Net cash used in investing activities	<u>(16,382)</u>	<u>—</u>	<u>(34,020,004)</u>
Cash flows from financing activities:			
Purchase of available for sale securities	—	—	(712,000)
Proceeds from issuance of subordinated notes	—	—	23,712,000
Purchase of treasury stock	(145,300)	—	—
Proceeds issuance of treasury stock	100,427	—	—
Cash dividends paid	<u>(3,503,575)</u>	<u>(3,502,672)</u>	<u>(3,377,576)</u>
Net cash provided by (used in) financing activities	<u>(3,548,448)</u>	<u>(3,502,672)</u>	<u>19,622,424</u>
Net increase (decrease) in cash and due from banks	1,671,318	(75,051)	(8,724,722)
Cash and due from banks at beginning of year	8,717,354	8,792,405	17,517,127
Cash and due from banks at end of year	<u>\$10,388,672</u>	<u>8,717,354</u>	<u>8,792,405</u>

During 2007, the Company changed the name of Citizen Union State Bank to Hawthorn Bank, and combined Osage Valley Bank, Bank 10 and Exchange National Bank into Hawthorn Bank. Concurrent with each combination, the underlying bank charters were sold to unrelated third parties for cash. Included in other income for 2007 is a gain from the sales of charters aggregating \$1,200,000.

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(18) Disclosures About Financial Instruments

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

The Company's extent of involvement and maximum potential exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for financial instruments included on its consolidated balance sheets. At December 31, 2007, no amounts have been accrued for any estimated losses for these financial instruments.

The contractual amount of off-balance-sheet financial instruments as of December 31, 2007 and 2006 is as follows:

	<u>2007</u>	<u>2006</u>
Commitments to extend credit	\$141,414,349	130,260,627
Standby letters of credit	5,680,483	3,996,657

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Of the total commitments to extend credit at December 31, 2007, approximately \$78,012,000 represents fixed-rate loan commitments. Of the total commitments to extend credit at December 31, 2006, approximately \$88,552,000 represents fixed-rate loan commitments. Since certain of the commitments and letters of credit are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, furniture and equipment, and real estate.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These standby letters of credit are primarily issued to support contractual obligations of the Company's customers. The credit risk involved in issuing letters of credit is essentially the same as the risk involved in extending loans to customers. The approximate remaining term of standby letters of credit range from one month to ten years at December 31, 2007.

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A summary of the carrying amounts and fair values of the Company's financial instruments at December 31, 2007 and 2006 is as follows:

	2007		2006	
	Carrying amount	Fair value	Carrying amount	Fair value
Assets:				
Loans	\$ 901,996,263	911,309,000	803,297,381	809,906,000
Investment in debt and equity securities	157,368,505	157,368,505	189,773,310	189,773,310
Federal fund sold and securities purchased under agreements to resell	664,184	664,184	9,922,961	9,922,961
Cash and due from banks	35,209,201	35,209,201	43,077,605	43,077,605
Mortgage servicing rights	1,184,868	2,750,000	1,350,375	3,010,000
Accrued interest receivable	8,764,196	8,764,196	8,773,686	8,773,686
	<u>\$1,105,187,217</u>	<u>1,116,065,086</u>	<u>1,056,195,318</u>	<u>1,064,463,562</u>
Liabilities:				
Deposits:				
Demand	\$ 138,355,520	138,355,520	138,885,883	138,885,883
NOW	116,635,508	116,635,508	108,886,884	108,886,884
Savings	43,183,790	43,183,790	48,249,204	48,249,204
Money market	169,402,365	169,402,365	151,737,295	151,737,295
Time	453,680,108	458,141,000	452,105,468	453,230,000
Federal funds purchased and securities sold under agreements to repurchase	25,729,863	25,729,863	29,460,492	29,460,492
Interest-bearing demand notes to U.S. Treasury	—	—	1,735,638	1,735,638
Subordinated notes	49,486,000	49,486,000	49,486,000	49,486,000
Other borrowed money	77,915,027	78,821,000	47,368,315	47,251,000
Accrued interest payable	4,723,965	4,723,965	4,366,250	4,366,250
	<u>\$1,079,112,146</u>	<u>1,084,479,011</u>	<u>1,032,281,429</u>	<u>1,033,288,646</u>

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

Loans

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type, such as real estate, installment and other consumer, commercial, and bankers' acceptances. Each loan category is further segmented into fixed and adjustable interest rate terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions.

The fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discount rates are judgmentally determined using available market and specific borrower information.

Investment in Debt and Equity Securities

Fair values are based on quoted market prices or dealer quotes.

Federal Funds Sold, Cash, and Due from Banks

For federal funds sold, cash, and due from banks, the carrying amount is a reasonable estimate of fair value, as such instruments reprice in a short time period.

Mortgage Servicing Rights

The fair value of mortgage servicing rights is based on the discounted value of contractual cash flows utilizing servicing rate, constant prepayment rate, servicing cost, and discount rate factors.

Accrued Interest Receivable and Payable

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

Deposits

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

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

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

Subordinated Notes

For subordinated notes, the carrying value is a reasonable estimate of fair value, as such instruments reprice in a short time period.

Other Borrowed Money

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

Commitments to Extend Credit and Standby Letters of Credit

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

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

(19) Litigation

Various legal claims have arisen in the normal course of business, which, in the opinion of management of the Company, will not result in any material liability to the Company.

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(20) Quarterly Financial Information

(unaudited)

(In thousands, except per share data)

	<u>First quarter</u>	<u>Second quarter</u>	<u>Third quarter 2007</u>	<u>Fourth quarter</u>	<u>Year-to-Date</u>
Interest income	\$ 18,031	18,137	18,992	19,047	74,207
Interest expense	8,895	9,052	9,667	9,561	37,175
Net interest income	<u>\$ 9,136</u>	<u>9,085</u>	<u>9,325</u>	<u>9,486</u>	<u>37,032</u>
Provision for loan losses	\$ 225	154	225	550	1,154
Noninterest income	2,524	2,849	2,095	2,753	10,221
Noninterest expense	8,134	8,445	8,161	10,314	35,054
Income taxes	994	972	897	382	3,245
Net income	2,307	2,363	2,137	993	7,800
Net income per share:					
Basic earnings per share	0.55	0.57	0.51	0.24	1.87
Diluted earnings per share	0.55	0.56	0.51	0.24	1.85
2006					
Interest income	\$ 16,793	17,930	18,314	18,386	71,423
Interest expense	7,334	8,095	8,589	8,748	32,766
Net interest income	<u>\$ 9,459</u>	<u>9,835</u>	<u>9,725</u>	<u>9,638</u>	<u>38,657</u>
Provision for loan losses	\$ 317	311	300	398	1,326
Noninterest income	2,026	2,249	2,216	2,109	8,600
Noninterest expense	7,312	7,458	7,482	7,896	30,148
Income taxes	1,167	1,383	1,301	1,057	4,908
Net income	2,689	2,932	2,858	2,396	10,875
Net income per share:					
Basic earnings per share	0.64	0.70	0.69	0.58	2.61
Diluted earnings per share	0.64	0.70	0.68	0.57	2.59

MARKET PRICE OF AND DIVIDENDS ON EQUITY SECURITIES AND RELATED MATTERS

Market Price. Our Company's common stock trades on Nasdaq's global select market under the stock symbol of "HWBK." Prior to our June 2007 name change, our stock symbol was EXJF. The following table sets forth the range of high and low bid prices of our Company's common stock by quarter for each quarter in 2007 and 2006 in which the stock was traded.

<u>2007</u>	<u>High</u>	<u>Low</u>
First Quarter	36.66	36.20
Second Quarter	36.30	31.04
Third Quarter	33.70	29.85
Fourth Quarter	31.85	24.50
 <u>2006</u>	 <u>High</u>	 <u>Low</u>
First Quarter	30.90	29.00
Second Quarter	30.52	28.21
Third Quarter	31.00	28.25
Fourth Quarter	33.24	29.70

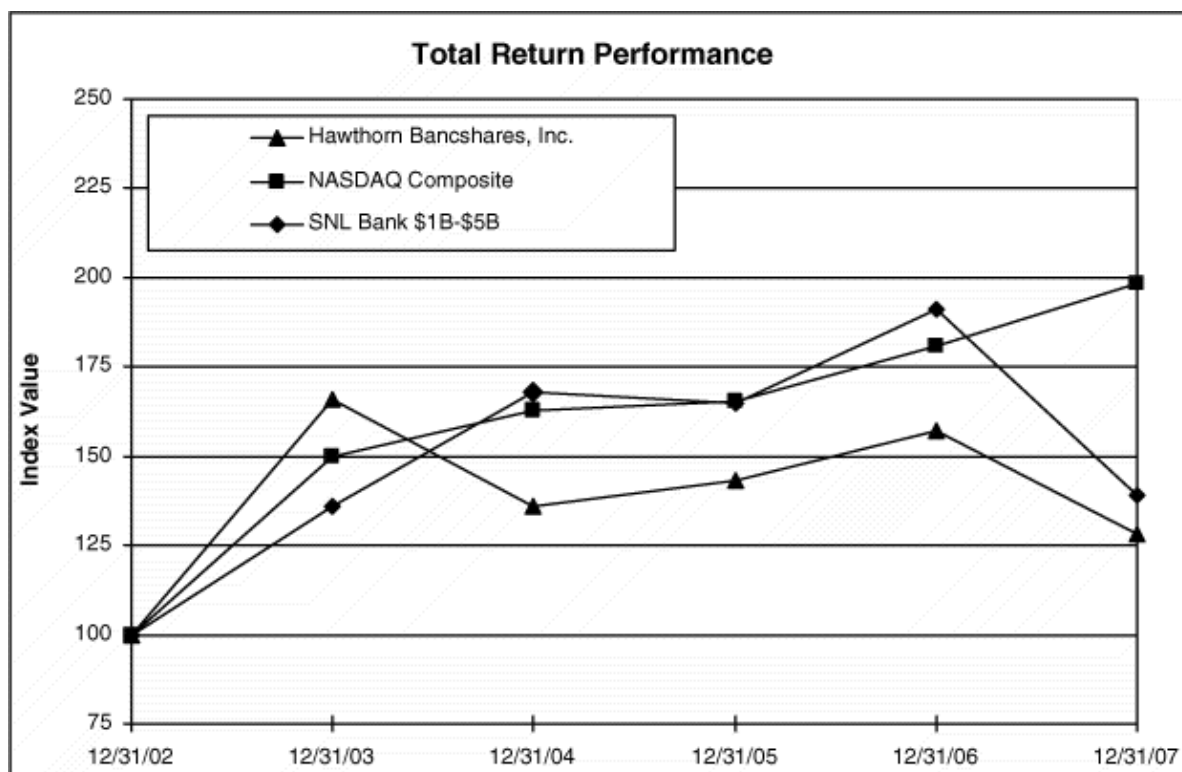
Shares Outstanding. As of March 3, 2008, our Company had issued 4,298,353 shares of common stock, of which 4,169,495 shares were outstanding. The outstanding shares were held of record by approximately 1,415 persons. The common stock is the only class of equity security which our Company has outstanding.

Dividends. The following table sets forth information on dividends paid by our Company in 2007 and 2006.

January, 2007	\$ 0.21
April, 2007	0.21
July, 2007	0.21
October, 2007	0.21
Total for 2007	<u>\$ 0.84</u>
 January, 2006	 \$ 0.21
April, 2006	0.21
July, 2006	0.21
October, 2006	0.21
Total for 2006	<u>\$ 0.84</u>

Our Board of Directors intends that our Company will continue to pay quarterly dividends at least at the current rate. The actual amount of quarterly dividends and the payment, as well as the amount, of any special dividend ultimately will depend upon the payment of sufficient dividends by our subsidiary Bank to our Company. The payment by our Bank of dividends to our Company will depend upon such factors as our Bank's financial condition, results of operations and current and anticipated cash needs, including capital requirements. As discussed in Note 3 to our Company's consolidated financial statements, the Bank may pay up to \$25,079,000 in dividends to our Company without regulatory approval subject to the ongoing capital requirements of the Bank.

Stock Performance Graph. The following performance graph shows a comparison of cumulative total returns for our Company, the Nasdaq Stock Market (U.S. Companies), and a peer index of financial institutions having total assets of between \$1 billion and \$5 billion for the period from December 31, 2002, through December 31, 2007. The cumulative total return on investment for each of the periods for our Company, the Nasdaq Stock Market (U.S. Companies) and the peer index is based on the stock price or index at January 1, 2003. The performance graph assumes that the value of an investment in our common stock and each index was \$100 at December 31, 2002 and that all dividends were reinvested. The information presented in the performance graph is historical in nature and is not intended to represent or guarantee future returns.



The comparison of cumulative total returns presented in the above graph was plotted using the following index values and common stock price values:

	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07
Hawthorn Bancshares, Inc.	\$100.00	\$165.94	\$135.91	\$143.00	\$156.94	\$128.00
Nasdaq Composite (U.S. Companies)	\$100.00	\$150.01	\$162.89	\$165.13	\$180.85	\$198.60
Index of financial institutions (\$1 billion to \$5 billion)	\$100.00	\$135.99	\$167.83	\$164.97	\$190.90	\$139.06

DIRECTORS AND EXECUTIVE OFFICERS OF OUR COMPANY

Name	Position with Our Company	Position with Subsidiary Bank	Principal Occupation
James E. Smith	Chairman, Chief Executive Officer and Director-Class I	Chairman, Chief Executive Officer, and Director of Hawthorn Bank	Position with Hawthorn Bancshares and Hawthorn Bank
David T. Turner	President and Director-Class III	President of East Region and Director of Hawthorn Bank	Position with Hawthorn Bancshares and Hawthorn Bank
Charles G. Dudenhoeffer, Jr.	Director-Class I	Director of Hawthorn Bank	Retired
Philip D. Freeman	Director-Class I	Director of Hawthorn Bank	Owner/Manager, Freeman Mortuary, Jefferson City, Missouri
Kevin L. Riley	Director-Class III	Director of Hawthorn Bank	Co-owner, Riley Chevrolet, Inc. and Riley Toyota, Scion, Cadillac, Inc., Jefferson City, Missouri
Julius F. Wall	Director-Class II	Director of Hawthorn Bank	Attorney, Poague, Wall, Eshelman, Cox & Adams, Clinton, Missouri
Gus S. Wetzel, II	Director-Class II	Director of Hawthorn Bank	Physician, Wetzel Clinic, Clinton, Missouri
Richard G. Rose	Chief Financial Officer	Senior Vice President and Chief Financial Officer of Hawthorn Bank	Position with Hawthorn Bancshares and Hawthorn Bank
Kathleen L. Bruegenhemke	Senior Vice President, Chief Risk Officer and Corporate Secretary		Position with Hawthorn Bancshares
James H. Taylor	Senior Vice President and Senior Credit Officer		Position with Hawthorn Bancshares

ANNUAL REPORT ON FORM 10-K

A copy of our Company's Annual Report on Form 10-K for the year ended December 31, 2007, as filed with the Securities and Exchange Commission, excluding exhibits, will be furnished without charge to shareholders entitled to vote at the 2008 annual meeting of shareholders upon written request to Kathleen L. Bruegenhemke, Secretary, Hawthorn Bancshares, Inc., 132 East High Street, Jefferson City, Missouri 65101. Our Company will provide a copy of any exhibit to the Form 10-K to any such person upon written request and the payment of our Company's reasonable expenses in furnishing such exhibits.

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Section 4: EX-21 (LIST OF SUBSIDIARIES)

LIST OF SUBSIDIARIES

Name of Subsidiary	Jurisdiction of Organization
Union State Bancshares, Inc.	Missouri
Hawthorn Bank	Missouri
Jefferson City IHC, LLC	Missouri (limited liability company)
Exchange National Statutory Trust I	Connecticut
Exchange National Statutory Trust II	Delaware

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Section 5: EX-23 (CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM)

Consent of Independent Registered Public Accounting Firm

The Board of Directors
Hawthorn Bancshares, Inc.:

We consent to the incorporation by reference in the registration statement (No. 333-68388) on Form S-8 of Hawthorn Bancshares, Inc. of our report dated March 14, 2008, with respect to the consolidated balance sheets of Hawthorn Bancshares, Inc. as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2007 and the effectiveness of internal control over financial reporting as of December 31, 2007, which report appears in the December 31, 2007 annual report on Form 10-K of Hawthorn Bancshares, Inc.

/s/ KPMG LLP

St. Louis, Missouri
March 14, 2008

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**Section 6: EX-31.1 (CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO RULE 13A-14(A) AND RULE 15D-14(A))**

CERTIFICATIONS

I, James E. Smith, certify that:

1. I have reviewed this report on Form 10-K of Hawthorn Bancshares, Inc.;
 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
 4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
 5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
-

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 14, 2008

/s/ James E. Smith

James E. Smith

Chairman of the Board and Chief Executive Officer

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Section 7: EX-31.2 (CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO RULE 13A-14(A) AND RULE 15D-14(A))

CERTIFICATIONS

I, Richard G. Rose, certify that:

1. I have reviewed this report on Form 10-K of Hawthorn Bancshares, Inc.;
 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
 4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
 5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
-

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 14, 2008

/s/ Richard G. Rose

Richard G. Rose

Chief Financial Officer

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Section 8: EX-32.1 (CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 906)

Certification of Chief Executive Officer

In connection with the Annual Report of Hawthorn Bancshares, Inc. (the “Company”) on Form 10-K for the year ended December 31, 2007 as filed with the Securities and Exchange Commission (the “Report”), I, James E. Smith, Chairman of the Board and Chief Executive Officer of the Company, hereby certify in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (a) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (b) The information contained in the Report fairly presents, in all material aspects, the financial condition and results of operations of the Company.

Dated: March 14, 2008

/s/ James E. Smith

James E. Smith

Chairman of the Board and Chief Executive Officer

“A signed original of this written statement required by Section 906 has been provided to Hawthorn Bancshares, Inc. and will be retained by Hawthorn Bancshares, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.”

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Section 9: EX-32.2 (CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 906)

Certification of Chief Financial Officer

In connection with the Annual Report of Hawthorn Bancshares, Inc. (the “Company”) on Form 10-K for the year ended December 31, 2007 as filed with the Securities and Exchange Commission (the “Report”), I, Richard G. Rose, Chief Financial Officer of the Company, hereby certify in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (a) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (b) The information contained in the Report fairly presents, in all material aspects, the financial condition and results of operations of the Company.

Dated: March 14, 2008

/s/ Richard G. Rose

Richard G. Rose
Chief Financial Officer

“A signed original of this written statement required by Section 906 has been provided to Hawthorn Bancshares, Inc. and will be retained by Hawthorn Bancshares, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.”