HAWTHORN BANCSHARES, INC.
Form 10-Q
August 14, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2012

or

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

Commission File Number: 0-23636

HAWTHORN BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

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

300 Southwest Longview Boulevard, Lee s Summit, Missouri 64081

(Address of principal executive offices) (Zip Code)

Top of Form

(816) 347-8100

(Registrant s telephone number, including area code)

N/A

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

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

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

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

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

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

As of August 14, 2012, the registrant had 4,839,114 shares of common stock, par value $1.00 per share, outstanding

Page 1 of 66 pages

Index to Exhibits located on page 61

Part I - FINANCIAL INFORMATION

Item 1. Financial Statements

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets ***(unaudited)***

	June 30, 2012	December 31, 2011
ASSETS		
Loans	$ 844,104,983	$ 842,930,548
Allowances for loan losses	(15,313,584)	(13,809,224)
Net loans	828,791,399	829,121,324
Investment in available-for-sale securities, at fair value	228,269,741	213,806,001
Federal funds sold and securities purchased under agreements to resell	75,000	75,000
Cash and due from banks	40,329,180	43,134,530
Premises and equipment - net	37,350,456	37,953,372
Other real estate owned and repossessed assets - net	21,582,893	16,020,023
Accrued interest receivable	5,280,353	5,340,610
Mortgage servicing rights	2,666,498	2,308,377
Intangible assets - net	336,710	542,746
Cash surrender value - life insurance	2,097,824	2,064,452
Other assets	20,439,155	20,794,988
Total assets	$ 1,187,219,209	$ 1,171,161,423
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits:		
Non-interest bearing demand	$ 169,124,794	$ 159,186,859
Savings, interest checking and money market	402,529,604	384,598,688
Time deposits $100,000 and over	130,193,612	139,504,648
Other time deposits	282,730,595	274,933,958
Total deposits	984,578,605	958,224,153
Federal funds purchased and securities sold under agreements to repurchase	23,843,510	24,516,277
Subordinated notes	49,486,000	49,486,000
Federal Home Loan Bank advances	28,280,725	28,409,989
Accrued interest payable	1,427,066	1,054,202
Other liabilities	7,461,732	6,895,029
Total liabilities	1,095,077,638	1,068,585,650
Stockholders equity:		
Preferred stock, $0.01 par value per share, 1,000,000 shares authorized;		
Issued 18,255 shares and 30,255, respectively, $1,000 per share liquidation value, net of discount	17,833,215	29,317,716
Common stock, $1 par value		
Authorized 15,000,000 shares; issued 4,814,852 shares respectively	4,814,852	4,814,852

Surplus	31,992,617	30,265,992
Retained earnings	39,570,876	40,354,112
Accumulated other comprehensive income, net of tax	1,446,829	1,339,919
Treasury stock; 161,858 shares, at cost	(3,516,818)	(3,516,818)
Total stockholders equity	92,141,571	102,575,773
Total liabilities and stockholders equity	$ 1,187,219,209	$ 1,171,161,423

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
INTEREST INCOME				
Interest and fees on loans	$ 10,944,089	$ 11,991,200	$ 22,186,297	$ 24,078,842
Interest on debt securities:				
Taxable	1,084,854	1,342,958	2,201,283	2,497,854
Nontaxable	227,439	254,093	462,083	529,901
Interest on federal funds sold and securities purchased under agreements to resell	20	25	35	62
Interest on interest-bearing deposits	15,627	11,695	36,900	32,288
Dividends on other securities	24,761	40,661	56,137	84,361
Total interest income	12,296,790	13,640,632	24,942,735	27,223,308
INTEREST EXPENSE				
Interest on deposits:				
Savings, interest checking and money market	328,064	447,813	653,498	931,504
Time deposit accounts $100,000 and over	308,900	432,649	537,566	895,821
Other time deposit accounts	1,004,691	1,315,987	1,788,696	2,738,789
Interest on federal funds purchased and securities sold under agreements to repurchase	4,755	12,628	9,444	25,983
Interest on subordinated notes	344,741	323,016	698,752	725,177
Interest on Federal Home Loan Bank advances	133,669	326,008	268,048	642,967
Total interest expense	2,124,820	2,858,101	3,956,004	5,960,241
Net interest income	10,171,970	10,782,531	20,986,731	21,263,067
Provision for loan losses	1,500,000	1,883,334	3,200,000	3,633,336
Net interest income after provision for loan losses	8,671,970	8,899,197	17,786,731	17,629,731
NON-INTEREST INCOME				
Service charges on deposit accounts	1,459,564	1,419,272	2,707,581	2,729,763
Trust department income	224,532	228,771	436,363	423,866
Gain on sale of mortgage loans, net	475,317	215,996	993,961	462,230
Other	283,747	314,585	275,551	614,845
Total non-interest income	2,443,160	2,178,624	4,413,456	4,230,704
NON-INTEREST EXPENSE				
Salaries and employee benefits	4,897,918	4,333,620	9,704,166	9,010,693
Occupancy expense, net	640,911	584,685	1,287,552	1,223,049
Furniture and equipment expense	467,535	509,104	970,658	1,015,783
FDIC insurance assessment	258,730	396,266	502,581	875,013
Legal, examination, and professional fees	259,193	307,105	595,915	797,609
Advertising and promotion	218,025	269,700	461,852	501,875
Postage, printing, and supplies	279,340	295,774	543,330	564,481
Processing expense	1,011,100	812,808	1,778,856	1,634,885
Other real estate expense	1,015,079	548,436	1,596,022	1,040,869
Other	1,049,868	950,627	2,136,937	1,721,592

Total non-interest expense		10,097,699		9,008,125		19,577,869		18,385,849
Income before income taxes		1,017,431		2,069,696		2,622,318		3,474,586
Income tax expense		277,400		661,202		431,552		1,112,475
Net income		740,031		1,408,494		2,190,766		2,362,111
Preferred stock dividends		295,723		382,390		665,506		752,173
Accretion of discount on preferred stock		396,380		119,118		515,499		238,237
Net income available to common shareholders	$	47,928	$	906,986	$	1,009,761	$	1,371,701
Basic earnings per share	$	0.01	$	0.19	$	0.21	$	0.28
Diluted earnings per share	$	0.01	$	0.19	$	0.21	$	0.28

See accompanying notes to the unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

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

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net income	$ 740,031	$ 1,408,494	$ 2,190,766	$ 2,362,111
Other comprehensive income, net of tax				
Unrealized gain on debt securities available-for-sale, net of tax	133,055	1,568,024	54,753	1,639,760
Defined benefit pension plans:				
Amortization of prior service cost included in net periodic pension cost, net of tax	26,079	11,991	52,157	23,982
Total other comprehensive income	159,134	1,580,015	106,910	1,663,742
Total comprehensive income	$ 899,165	$ 2,988,509	$ 2,297,676	$ 4,025,853

See accompanying notes to the unaudited consolidated financial statements

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

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

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stock - holders Equity
Balance, January 1, 2011	$ 28,841,242	$ 4,635,891	$ 28,928,545	$ 41,857,302	$ 742,149	$ (3,516,818)	$ 101,488,311
Net income				2,362,111			2,362,111
Other comprehensive income					1,663,742		1,663,742
Stock based compensation expense			33,877				33,877
Accretion of preferred stock discount	238,237			(238,237)			
Stock dividend			1,458,534	(1,458,534)			
Cash dividends declared, preferred stock				(756,376)			(756,376)
Cash dividends declared, common stock				(447,404)			(447,404)
Balance, June 30, 2011	**$ 29,079,479**	**$ 4,635,891**	**$ 30,420,956**	**$ 41,318,862**	**$ 2,405,891**	**$ (3,516,818)**	**$ 104,344,261**
Balance, December 31, 2011	$ 29,317,716	4,814,852	30,265,992	40,354,112	1,339,919	(3,516,818)	$ 102,575,773
Cumulative effect of change in accounting principle				459,890			459,890
Balance, January 1, 2012	$ 29,317,716	$ 4,814,852	$ 30,265,992	$ 40,814,002	$ 1,339,919	$ (3,516,818)	$ 103,035,663
Net income				2,190,766			2,190,766
Other comprehensive income					106,910		106,910

Stock based compensation expense			19,906				19,906
Accretion of preferred stock discount	515,499			(515,499)			
Redemption of 12,000 shares of preferred stock	(12,000,000)						(12,000,000)
Stock dividend			1,706,719	(1,706,719)			
Cash dividends declared, preferred stock				(746,375)			(746,375)
Cash dividends declared, common stock				(465,299)			(465,299)
Balance, June 30, 2012	**$ 17,833,215**	**$ 4,814,852**	**$ 31,992,617**	**$ 39,570,876**	**$ 1,446,829**	**$ (3,516,818)**	**$ 92,141,571**

See accompanying notes to the unaudited consolidated financial statements

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (*unaudited*)

	Six Months Ended June 30, 2012	2011
Cash flows from operating activities:		
Net income	$ 2,190,766	$ 2,362,111
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	3,200,000	3,633,336
Depreciation expense	1,002,347	963,122
Net amortization of debt securities, premiums, and discounts	548,876	406,130
Amortization of intangible assets	206,036	226,713
Stock based compensation expense	19,906	33,877
Change in fair value of mortgage servicing rights	711,978	
(Gain) loss on sales and dispositions of premises and equipment	(60,116)	667
(Gain) loss on sales and dispositions of other real estate owned and repossessions	(75,093)	258,885
Provision for other real estate owned	739,412	440,805
Decrease in accrued interest receivable	60,257	61,345
Increase in cash surrender value - life insurance	(33,372)	(34,232)
Decrease in other assets	267,680	277,522
(Increase) decrease in income tax receivable	(687,408)	1,112,475
Increase in accrued interest payable	372,864	199,491
Increase in other liabilities	823,104	777,683
Origination of mortgage loans for sale	(38,363,488)	(23,115,786)
Proceeds from the sale of mortgage loans	40,437,045	22,336,960
Gain on sale of mortgage loans, net	(993,961)	(462,230)
Decrease in net deferred tax asset	33,346	15,332
Other, net	52,157	23,982
Net cash provided by operating activities	10,452,336	9,518,188
Cash flows from investing activities:		
Net (increase) decrease in loans	(13,260,765)	20,636,247
Purchase of available-for-sale debt securities	(63,135,227)	(83,043,472)
Proceeds from maturities of available-for-sale debt securities	21,927,370	19,097,740
Proceeds from calls of available-for-sale debt securities	26,285,000	25,508,000
Proceeds from sales of FHLB stock	97,000	1,077,100
Purchases of premises and equipment	(843,180)	(1,487,479)
Proceeds from sales of premises and equipment	247,464	34,249
Proceeds from sales of other real estate owned and repossessions	3,083,905	3,421,481
Net cash used by investing activities	(25,598,433)	(14,756,134)
Cash flows from financing activities:		
Net increase in demand deposits	9,937,935	10,390,244
Net increase in interest-bearing transaction accounts	17,930,916	6,971,783
Net decrease in time deposits	(1,514,399)	(1,952,085)
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(672,767)	(1,378,786)
Repayment of Federal Home Loan Bank advances	(129,264)	(23,329,310)
Redemption of 12,000 shares of preferred stock	(12,000,000)	
Cash dividends paid - preferred stock	(746,375)	(756,376)
Cash dividends paid - common stock	(465,299)	(447,404)
Net cash provided (used) by financing activities	12,340,747	(10,501,934)

Net decrease in cash and cash equivalents	(2,805,350)	(15,739,880)
Cash and cash equivalents, beginning of year	43,209,530	50,979,800
Cash and cash equivalents, end of year	$ 40,404,180	$ 35,239,920

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES

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

	Six Months Ended June 30, 2012	2011
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	$ 3,951,832	$ 5,760,750
Income taxes	$ 1,260,000	$
Supplemental schedule of noncash investing and financing activities:		
Other real estate and repossessions acquired in settlement of loans	$ 9,311,094	$ 5,943,302

See accompanying notes to unaudited consolidated financial statements.

HAWTHORN BANCSHARES, INC.

AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

(1) Summary of Significant Accounting Policies

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

The accompanying unaudited consolidated financial statements of our Company have been prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instruction to Form 10-Q, and Rule 10-01 of Regulation S-X. According the unaudited consolidated financial statements do not include all of the information and disclosures required by U.S. GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes included in our Company s Annual Report on Form 10-K for the year ended December 31, 2011.

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

The following represents significant new accounting principles adopted in 2012:

Repurchase Agreements In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-03, Rec*onsideration of Effective Control for Repurchase Agreements*, which deals with the accounting for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The provisions of ASU No. 2011-03 modify the criteria for determining when repurchase agreements would be accounted for as a secured borrowing rather than as a sale. Currently, an entity that maintains effective control over transferred financial assets must account for the transfer as a secured borrowing rather than as a sale. ASU No. 2011-03 removes from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee. The FASB believes that contractual rights and obligations determine effective control and that there does not need to be a requirement to assess the ability to exercise those rights. ASU No. 2011-03 does not change the other existing criteria used in the assessment of effective control. Our Company adopted the provisions of ASU No. 2011-03 prospectively for transactions or modifications of existing transactions that occurred on or after January 1, 2012. As our Company accounted for all of its repurchase agreements as collateralized financing arrangements prior to the adoption of ASU No. 2011-03, the adoption had no impact on the Company s Consolidated Financial Statements.

Fair Value Measurements In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (IFRSs)*, to substantially converge the guidance in U.S. GAAP and IFRS on fair value measurements and disclosures. The provisions of ASU No. 2011-04 result in a consistent definition of fair value and common requirements for the measurement of and disclosure about fair value between U.S. GAAP and IFRS. The changes to U.S. GAAP as a result of ASU No. 2011-04 are as follows: (1) The concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets. ASU No. 2011-04 extends that prohibition to all fair value measurements; (3) An exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity s net exposure to

HAWTHORN BANCSHARES, INC.

AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) Aligns the fair value measurement of instruments classified within an entity s shareholders equity with the guidance for liabilities; and (5) Disclosure requirements have been enhanced for Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to qualitatively describe the sensitivity of fair value measurements to changes in unobservable inputs and the interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. Our Company adopted the provisions of ASU No. 2011-04 effective January 1, 2012. The fair value measurement provisions of ASU No. 2011-04 had no impact on our Company s Consolidated Financial Statements. See Notes 11 and 12 to the Consolidated Financial Statements for the enhanced disclosures required by ASU No. 2011-04.

Other Comprehensive Income In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*, which revises the manner in which entities present comprehensive income in their financial statements. The provisions of ASU No. 2011-05 allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Under either method, entities are required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. ASU No. 2011-05 also eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders equity but does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU 2011-05 is effective for periods beginning January 1, 2012 and requires retrospective application. ASU No. 2011-05 was effective for our Company s interim reporting period beginning on or after January 1, 2012, with retrospective application required.

In December 2011, the FASB issued ASU No. 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. The provisions of ASU No. 2011-12 defer indefinitely the requirement for entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. ASU No. 2011-12, which shares the same effective date as ASU No. 2011-05, does not defer the requirement for entities to present components of comprehensive income in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Our Company adopted the provisions of ASU No. 2011-05 and ASU No. 2011-12 which resulted in a new statement of comprehensive income for the interim period ended June 30, 2012. The adoption of ASU No. 2011-05 and ASU No. 2011-12 had no impact on our Company s statements of income and condition.

Servicing Financial Assets On January 1, 2012, our Company opted to measure mortgage servicing rights at fair value as permitted by Accounting Standards Codification (ASC) Topic 860-50 *Accounting for Servicing Financial Assets*. Consistent with ASC 860-50-35-3d, an entity may make an irrevocable decision to subsequently measure a class of servicing assets and servicing liabilities at fair value at the beginning of any fiscal year. The election of this option resulted in the recognition of a cumulative effect of change in accounting principle of $459,890, net of tax in the amount of $281,868, which was recorded as an increase to beginning retained earnings, as further described in Note 5 to the consolidated financial statements. As such, effective January 1, 2012, the change in the fair value of mortgage servicing rights are recognized in earnings in the period for which the change occurs. The newly adopted accounting principle is preferable in the circumstances because the fair value measurement method will produce financial information and results more directly aligned with the performance of mortgage servicing rights.

The complete set of significant accounting policies followed in the preparation of the quarterly financial statements are disclosed in the Annual Report on Form 10-K for the year ended December 31, 2011.

HAWTHORN BANCSHARES, INC.

AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

Stock Dividend On July 1, 2012, our Company paid a special stock dividend of four percent to common shareholders of record at the close of business on June 15, 2012. For all periods presented, share information, including basic and diluted earnings per share, have been adjusted retroactively to reflect this change.

(2) Loans and Allowance for Loan Losses

A summary of loans, by major class within our Company s loan portfolio, at June 30, 2012 and December 31, 2011 are as follows:

	June 30, 2012	December 31, 2011
Commercial, financial, and agricultural	$ 128,857,496	$ 128,555,173
Real estate construction - residential	19,830,700	30,201,198
Real estate construction - commercial	42,841,472	47,696,759
Real estate mortgage - residential	220,334,153	203,454,204
Real estate mortgage - commercial	404,469,004	402,960,327
Installment and other consumer	27,591,103	29,883,986
Unamortized loan origination fees and costs, net	181,055	178,901
Total loans	$ 844,104,983	$ 842,930,548

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. At June 30, 2012, loans with a carrying value of $453,772,000 were pledged to Federal Home Loan Bank as collateral for borrowings and letters of credit.

HAWTHORN BANCSHARES, INC.

AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(Unaudited)

Allowance for loan losses

The following is a summary of the allowance for loan losses for the three and six months ended June 30, 2012 and 2011:

	For the Three Months Ended June 30, 2012							
(in thousands)	**Commercial, Financial, and Agricultural**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment Loans to Individuals**	**Unallocated**	**Total**
Balance, beginning of period	**$ 2,722**	**$ 727**	**$ 1,410**	**$ 3,563**	**$ 5,976**	**$ 237**	**$ 5**	**$ 14,640**
Additions:								
Provision for loan losses	363	(54)	211	380	525	63	12	1,500
Deductions:								
Loans charged off	69			422	438	132		1,061
Less recoveries on loans	(29)	(36)	(23)	(39)	(44)	(64)		(235)
Net loans charged off	40	(36)	(23)	383	394	68		826
Balance, end of period	**$ 3,045**	**$ 709**	**$ 1,644**	**$ 3,560**	**$ 6,107**	**$ 232**	**$ 17**	**$ 15,314**

	For the Six Months Ended June 30, 2012							
(in thousands)	**Commercial, Financial, and Agricultural**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment Loans to Individuals**	**Unallocated**	**Total**
Balance, beginning of period	**$ 1,804**	**$ 1,188**	**$ 1,562**	**$ 3,251**	**$ 5,734**	**$ 267**	**$ 3**	**$ 13,809**
Additions:								
Provision for loan losses	1,230	(546)	59	795	1,552	96	14	3,200
Deductions:								
Loans charged off	104			577	1,300	271		2,252
Less recoveries on loans	(115)	(67)	(23)	(91)	(121)	(140)		(557)
Net loans charged off	(11)	(67)	(23)	486	1,179	131		1,695
Balance, end of period	**$ 3,045**	**$ 709**	**$ 1,644**	**$ 3,560**	**$ 6,107**	**$ 232**	**$ 17**	**$ 15,314**

	For the Three Months Ended June 30, 2011							
(in thousands)	**Commercial, Financial, and Agricultural**	**Real Estate Construction - Residential**	**Real Estate Construction - Commercial**	**Real Estate Mortgage - Residential**	**Real Estate Mortgage - Commercial**	**Installment Loans to Individuals**	**Unallocated**	**Total**
Balance, beginning of period	**$ 2,257**	**$ 991**	**$ 1,356**	**$ 3,118**	**$ 3,709**	**$ 223**	**$ 748**	**$ 12,402**
Additions:								
Provision for loan losses	313	(6)	(276)	306	1,264	62	220	1,883
Deductions:								
Loans charged off	45			466	160	138		809