BLACKHAWK BANCORP INC
Form 10QSB
August 12, 2004

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

FORM 10-QSB

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15 (D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2004

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(D)
OF THE EXCHANGE ACT

FOR THE TRANSITION PERIOD FROM ---- TO ----

COMMISSION FILE NUMBER 0-18599

BLACKHAWK BANCORP, INC.
(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

WISCONSIN	39-1659424
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I. R. S. EMPLOYER IDENTIFICATION NO.)

400 BROAD STREET
BELOIT, WISCONSIN 53511
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

(608) 364-8911
(ISSUER'S TELEPHONE NUMBER)

NOT APPLICABLE

(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 X NO ___

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

CLASS OF COMMON STOCK	OUTSTANDING AT JULY 31, 2004
$.01 PAR VALUE	2,526,145 SHARES

Transitional Small Business Disclosure Format (Check one): Yes ___ No X

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PART I - FINANCIAL INFORMATION

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2004 (UNAUDITED) AND DECEMBER 31, 2003

	JUNE 30, 2004	DECEMBER 2003
ASSETS	(Dollars in thousands)	

Cash and due from banks	$ 14,813	$ 17,25
Federal funds sold and securities purchased under agreements to resell	5,294	6,12
Interest-bearing deposits in banks	2,012	2,84
Available-for-sale securities	129,584	118,10
Held to maturity securities, at amortized cost	-0-	17,60
Loans, less allowance for loan losses of $2,508 and $3,302 at June 30, 2004 and December 31, 2003, respectively	231,723	230,14
Office buildings and equipment, net	9,657	9,98
Intangible assets	7,048	7,24
Bank-owned life insurance	6,395	6,26
Other assets	9,385	9,84
Total Assets	$415,911	$425,40

LIABILITIES AND STOCKHOLDERS' EQUITY

LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 49,190	$ 47,99
Interest-bearing	257,536	275,64
Total deposits	306,726	323,63
Short-term borrowings	16,887	9,48
Subordinated debentures	7,217	7,21
Long-term borrowings	57,232	55,91
Other liabilities	2,651	3,38
Total Liabilities	390,713	399,63
STOCKHOLDERS' EQUITY:		
Preferred stock 1,000,000 shares, $.01 par value per share authorized, none issued or outstanding	--	-
Common stock 10,000,000 shares, $.01 par value per share authorized, shares issued and outstanding: 2,526,145 at June 30, 2004, 2,522,995 at December 31, 2003	25	2
Surplus	8,845	8,81
Retained earnings	16,470	16,09
Accumulated other comprehensive income (loss)	(142)	82
Total Stockholders' Equity	25,198	25,76
Total Liabilities and Stockholders' Equity	$415,911	$425,40

See Notes to Unaudited Consolidated Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

	THREE MONTHS ENDED JUNE 30,	
	2004	2003

	(Dollars in thousands, except per share	
INTEREST INCOME:		
Interest and fees on loans	$3,472	$3,065
Interest and dividends on securities:		
Taxable	922	929
Nontaxable	306	282
Interest on federal funds sold and securities purchased under agreements to resell	18	7
Interest on interest-bearing deposits in banks	13	8
Total Interest Income	4,731	4,291
INTEREST EXPENSE:		
Interest on deposits	1,076	1,230
Interest on short-term borrowings	23	41
Interest on subordinated debentures	103	84
Interest on long-term borrowings	561	530
Total Interest Expense	1,763	1,885
Net Interest Income	2,968	2,406
Provision for loan losses	103	142
Net Interest Income After Provision For Loan Losses	2,865	2,264
NONINTEREST INCOME:		
Service charges on deposit accounts	629	365
Gain on sale of loans	208	141
Securities gains, net	72	95
Increase in cash value of bank-owned life insurance	71	77
Other	220	204
Total Noninterest Income	1,200	882
NONINTEREST EXPENSES:		
Salaries and employee benefits	1,837	1,360
Occupancy	255	179
Equipment	300	231
Data processing services	272	203
Advertising and marketing	117	143
Amortization of intangibles	95	79
Professional fees	116	116
Office supplies	58	55
Telephone	96	79
Postage	51	60
Transportation	64	52
Other	307	258
Total Noninterest Expenses	3,568	2,815
Income Before Income Taxes	497	331
Income Taxes	71	1
Net Income	$ 426	$ 330
Basic Earnings Per Share	$ 0.17	$ 0.13
Diluted Earnings Per Share	$ 0.17	$ 0.13
Dividends Per Share	$ 0.09	$ 0.09

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See Notes to Unaudited Consolidated Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

	SIX MONTHS ENDED JUNE 30, 2004	2003
	(Dollars in thousands, except per share	
INTEREST INCOME:		
Interest and fees on loans	$7,013	$6,327
Interest and dividends on securities:		
Taxable	1,978	1,857
Nontaxable	619	535
Interest on federal funds sold and securities purchased under agreements to resell	31	49
Interest on interest-bearing deposits in banks	30	18
Total Interest Income	9,671	8,786
INTEREST EXPENSE:		
Interest on deposits	2,200	2,496
Interest on short-term borrowings	52	76
Interest on subordinated debentures	206	168
Interest on long-term borrowings	1,121	1,035
Total Interest Expense	3,579	3,775
Net Interest Income	6,092	5,011
Provision for loan losses	207	365
Net Interest Income After Provision For Loan Losses	5,885	4,646
NONINTEREST INCOME:		
Service charges on deposit accounts	1,115	704
Gain on sale of loans	355	301
Securities gains, net	152	424
Increase in cash value of bank-owned life insurance	140	153
Other	466	340
Total Noninterest Income	2,228	1,922
NONINTEREST EXPENSES:		
Salaries and employee benefits	3,655	2,818
Occupancy	545	369
Equipment	608	461
Data processing services	550	399
Advertising and marketing	210	207
Amortization of intangibles	190	159
Professional fees	244	302
Office supplies	130	117
Telephone	192	153
Postage	102	116
Transportation	128	96
Other	596	583
Total Noninterest Expenses	7,150	5,780

Income Before Income Taxes	963	788
Income Taxes	131	61
Net Income	$ 832	$ 727
Basic Earnings Per Share	$ 0.33	$ 0.29
Diluted Earnings Per Share	$ 0.33	$ 0.29
Dividends Per Share	$ 0.18	$ 0.18

See Notes to Unaudited Consolidated Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	SIX MONTHS ENDED JUNE 30, 2004	2003
	(Dollars in thousands)	
Common stock:		
Balance at beginning of period	$ 25	$ 25
Stock options exercised	--	--
Balance at end of period	25	25
Surplus:		
Balance at beginning of period	8,818	8,698
Stock options exercised	27	75
Balance at end of period	8,845	8,773
Retained earnings:		
Balance at beginning of period	16,092	15,788
Net income	832	727
Dividends declared on common stock	(454)	(453)
Balance at end of period	16,470	16,062
Accumulated other comprehensive income (loss):		
Balance at beginning of period	828	1,287
Other comprehensive income (loss), net of taxes	(970)	(5)
Balance at end of period	(142)	1,282
Total Stockholders' Equity	$25,198	$26,142

See Notes to Unaudited Consolidated Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

	SIX MONTHS ENDED JUNE 30, 2004	200
	(Dollars in thousand	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 832	$
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	706	
Provision for loan losses	207	
Gain on sale of loans	(355)	(
FHLB stock dividends	(167)	(
Amortization of premiums on securities, net	509	
Securities gains, net	(152)	(
Decrease in accrued interest receivable	241	
Decrease in accrued interest payable	(119)	
(Increase) decrease in other assets	64	(
Increase (decrease) in other liabilities	14	(1,
Net cash provided by operations before loan originations and sales	1,780	
Origination of loans for sale	(25,349)	(15,
Proceeds from sale of loans	24,506	16,
Net cash provided by operating activities	937	1,
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease in interest-bearing deposits in banks	829	6,
Net decrease in federal funds sold and securities purchased under agreements to resell	826	13,
Proceeds from sales of available-for-sale securities	25,274	23,
Proceeds from maturities and calls of available-for-sale securities	17,525	20,
Proceeds from maturities and calls of held-to-maturity securities	1,188	3,
Purchase of available-for-sale securities	(39,960)	(62,
Net (increase) decrease in loans	(1,711)	
Proceeds from the sale of office buildings, equipment, and other real estate owned	1,333	
Purchase of office buildings and equipment, net	(222)	(
Net cash provided by investing activities	5,082	6,
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net decrease in deposits	(16,776)	(14,
Dividends paid	(454)	(
Proceeds from long-term borrowings	6,000	8,
Payments on long-term borrowings	(4,650)	(
Net increase (decrease) in short-term borrowings	7,401	(1,
Proceeds from exercise of stock options	23	
Net cash used in financing activities	(8,456)	(8,
Net decrease in cash and due from banks	(2,437)	(
CASH AND DUE FROM BANKS:		

Beginning	17,250	12,
Ending	$ 14,813	$ 12,
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid (refunded) during the period for:		
Interest	$ 3,866	$ 3,
Income taxes	$ (160)	$ (
SUPPLEMENTAL SCHEDULES OF NON-CASH INVESTING ACTIVITIES:		
Change in accumulated other comprehensive income:		
Unrealized losses on available-for-sale securities, net	$ (1,026)	$
Unrealized gain on interest rate swap contract, net	$ 56	$
Other assets acquired in settlement of loans	$ 1,040	$

See Notes to Unaudited Consolidated Financial Statements.

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2004

Note 1. General:

The unaudited consolidated financial statements include the accounts of Blackhawk Bancorp, Inc. and its subsidiary. Effective September 30, 2003, Blackhawk Bancorp, Inc. acquired the assets of DunC Corp. and its subsidiary, First Bank, bc., in a transaction accounted for as a purchase. The assets and liabilities and results of operations of those acquired companies have been included in the consolidated financial statements of Blackhawk Bancorp, Inc. subsequent to the date of acquisition and affect comparability of 2004 results with 2003.

In the opinion of management, all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the financial position, results of operation and cash flows for the interim periods have been made. The results of operations for the three and six months ended June 30, 2004 are not necessarily indicative of the results to be expected for the entire fiscal year.

The unaudited interim financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and industry practice. Certain information in footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America and industry practice has been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission. The more significant policies used by the Company in preparing and presenting its financial statements are stated in the Company's Form 10-KSB. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's December 31, 2003 audited financial statements.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, as well as the reported amounts of income and expenses during the reported periods. Actual results could differ from those estimates.

Certain reclassifications have been made to the 2003 historical financial statements to conform to the 2004 presentation with no effect on net income or stockholders' equity.

Stock-Based Compensation Plan: The Company's stock-based director, key officer and employee compensation plans expired on December 31, 2003. The Company accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No stock-based employee compensation cost is reflected in income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The table on the following page illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation. The pro-forma compensation expense is recognized over the three year option vesting period.

(Dollars in thousands, except per share data)	THREE MONTHS END 2004
Net income, as reported	$ 426
Deduct total stock-based employee and director compensation expense determined under fair value based method for all awards, net of related tax effects	(18)
PRO FORMA NET INCOME	$ 408
Earnings per share:	
Basic:	
As reported	$0.17
Pro forma	0.16
Diluted:	
As reported	0.17
Pro forma	0.16

(Dollars in thousands, except per share data)	SIX MONTHS ENDED 2004
Net income, as reported	$ 832
Deduct total stock-based employee and director compensation expense determined under fair value based method for all awards, net of related tax effects	(35)
PRO FORMA NET INCOME	$ 797

Earnings per share:	
Basic:	
As reported	$0.33
Pro forma	0.32
Diluted:	
As reported	0.33
Pro forma	0.31

In determining compensation cost using the fair value method prescribed in Statement No. 123, the value of each grant is estimated at the grant date with the following weighted-average assumptions used for grants in 2003 and 2002, respectively: dividend yield of 3 percent and 4 percent; expected price volatility of 23 percent and 25 percent; risk-free interest rates of 3 percent and 4 percent; and expected lives of 7 years and 10 years, respectively.

Note 2. Allowance for Loan Losses

A summary of transactions in the allowance for loan losses is as follows:

	THREE MONTHS ENDED JUNE 30, (Dollars in thousands)	
	2004	2003
Balance at beginning of period	$3,173	$2,197
Provision charged to expense	103	142
Loans charged off	844	90
Recoveries	76	93
Balance at end of period	$2,508	$2,342

	SIX MONTHS ENDED JUNE 30, (Dollars in thousands)	
	2004	2003
Balance at beginning of period	$3,302	$2,079
Provision charged to expense	207	365
Loans charged off	1,101	247
Recoveries	100	145
Balance at end of period	$2,508	$2,342

Note 3. Earnings Per Share

Presented below are the calculations for basic and diluted earnings per share:

	THREE MONTHS ENDED JUNE 30,		SIX MON JUN
	2004	2003	2004

Basic:			
Net income available to common stockholders	$ 426,000	$ 330,000	$ 832,000
Weighted average shares outstanding	2,526,145	2,517,219	2,525,308
Basic earnings per share	$ 0.17	$ 0.13	$ 0.33
Diluted:			
Net income available to common stockholders	$ 426,000	$ 330,000	$ 832,000
Weighted average shares outstanding	2,526,145	2,517,219	2,525,308
Effect of dilutive stock options outstanding	30,540	17,267	30,540
Diluted weighted average shares outstanding	2,556,685	2,534,486	2,555,848
Diluted earnings per share	$ 0.17	$ 0.13	$ 0.33

Note 4. Derivative Instrument

During June 2003, the Company entered into an interest rate swap transaction, which resulted in the Company converting $7,000,000 of its $7,217,000 of variable rate subordinated debentures into fixed rate debt. This swap transaction requires the payment of interest by the Company at a fixed rate equal to 2.47% using an actual/360 day basis. In turn the Company receives a variable rate interest payment based on the 90 day LIBOR rate adjusted quarterly.

Summary information about the interest rate swap at June 30 is as follows:

	2004	2003
	(Dollars in thousands)	
Notional amount	$7,000	$7,000
Weighted average fixed rate	2.51%	2.51%
Weighted average variable rate	1.61%	1.02%
Weighted average maturity	3.5 years	4.5 years
Fair value	$308	$69

Note 5. Acquisition of DunC Corp.

As more fully described in Item 2 of this report under the caption "Acquisition or Disposition of Assets", Blackhawk Bancorp, Inc. acquired DunC Corp. on September 30, 2003 in a transaction accounted for as a purchase. The assets and liabilities of DunC Corp., valued at fair market value, on the date of acquisition are included in the unaudited consolidated balance sheet of Blackhawk Bancorp, Inc. and Subsidiary at June 30, 2004 and in the audited consolidated balance sheet of Blackhawk Bancorp, Inc. and Subsidiary at December 31, 2003. The results of operations have been included in the unaudited consolidated statements of income for the three and six months ended June 30, 2004 and will affect the comparability to 2003 results.

Note 6. Sale of Branches Located in Rochelle and Oregon, Illinois

As more fully described in Item 2 of this report under the caption "Acquisition or Disposition of Assets", on June 22, 2004 Blackhawk State Bank entered into a definitive agreement for the sale of its branches located in the Illinois communities of Rochelle and Oregon. The sale includes only the branch facilities and deposits, not loans. The two branches currently have approximately $35 million in combined deposits. The transaction, which is subject to regulatory and other customary closing conditions, is expected to close in the fourth quarter of 2004. In accordance with generally accepted accounting principals, the assets and liabilities of these two branches and their results of operations and cash flows have been included in the financial statements of Blackhawk Bancorp, Inc. for all periods presented.

Note 7. Recent Accounting Developments

FIN No. 46 Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51 (Revised December 2003). FIN 46 establishes accounting guidance for consolidation of variable interest entities (VIE) that function to support the activities of the primary beneficiary. The primary beneficiary of a VIE is the entity that absorbs a majority of the VIE's expected losses, receives a majority of the VIE's expected residual returns, or both, as a result of ownership, controlling interest, contractual relationship or other business relationship with a VIE. Prior to the implementation of FIN 46, VIEs were generally consolidated by an enterprise when the enterprise had a controlling financial interest through ownership of a majority of voting interest in the entity. The provisions of FIN 46 were effective immediately for all arrangements entered into after January 31, 2003. However, subsequent revisions to the interpretation deferred the implementation date of FIN 46 until the first period ending after March 15, 2004.

The Company adopted FIN 46, as revised, in connection with its consolidated financial statements for the quarter ended March 31, 2004. The implementation of FIN 46 required the Company to de-consolidate its investment in Blackhawk Statutory Trust I (the "Trust") because the Company is not the primary beneficiary. There was no impact on stockholders' equity, or net income upon adoption of the standard.

The trust preferred securities issued by the Trust are currently included in the Tier 1 capital of the Company for regulatory capital purposes. However, because the financial statements of the Trust will no longer be included in the Company's consolidated financial statements, the Federal Reserve Board may in the future disallow inclusion of the trust preferred securities in Tier 1 capital for regulatory capital purposes. In July 2003, the Federal Reserve Board issued a supervisory letter instructing bank holding companies to continue to include the trust preferred securities in their Tier 1 capital for regulatory capital purposes until notice is given to the contrary. On May 6, 2004 the Federal Reserve Board issued a proposed rule limiting the amount of trust preferred securities eligible for inclusion in Tier 1 capital to 25% of core capital elements, net of goodwill. This proposed change would be fully effective on March 31, 2007 after a three year phase in period. The proposed rule will limit the Company's trust preferred securities eligible for inclusion in Tier 1 capital to $6,870,000. Under the proposed rule, the balance of the Company's trust preferred securities will be included in Tier 2 capital. There can be no assurance that the Federal Reserve Board will continue to permit institutions to include trust preferred securities in Tier 1 capital for regulatory capital purposes.

Note 8. Recent Regulatory Developments

The Sarbanes-Oxley Act of 2002 (the "Act") impacts corporate governance of public companies, affecting their officers and directors, their audit committees, their relationships with their accountants and the audit function itself. Certain provisions of the Act became effective on July 30, 2002. The requirements of Section 404 of the Act become effective for the Company for the year ended December 31, 2005. Section 404 requires an evaluation of and report on the Company's internal control environment and an auditors' opinion on managements' evaluation of internal control.

The Act implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and better protect investors from corporate wrongdoing. The Act includes the creation of an independent accounting oversight board to oversee the audit of public companies and their auditors, provisions restricting non-audit services performed by independent accountants for public companies and additional corporate governance and responsibility provisions.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The purpose of Management's discussion and analysis is to provide relevant information regarding the Registrant's financial condition and its results of operations. The information included herein should be read in conjunction with the company's consolidated financial statements and footnotes thereto for the year ended December 31, 2003.

This report contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to the financial condition, results of operations, plans, objectives, future performance and business of Blackhawk Bancorp, Inc. Statements that are not historical facts, including statements about beliefs and expectations, are forward-looking statements. These statements are based upon beliefs and assumptions of Blackhawk's management and on information currently available to such management. The use of the words "believe", "expect", "anticipate", "plan", "estimate", "may", "will" or similar expressions are forward-looking statements.

Contemplated, projected, forecasted or estimated results in such forward-looking statements involve certain inherent risks and uncertainties. A number of factors - many of which are beyond the ability of the company to control or predict - could cause actual results to differ materially from those described in the forward-looking statements. Factors which could cause such a variance to occur include, but are not limited to: heightened competition; adverse state and federal regulation; failure to obtain new or retain existing customers; ability to attract and retain key executives and personnel; changes in interest rates; unanticipated changes in industry trends; unanticipated changes in credit quality and risk factors, including general economic conditions; success in gaining regulatory approvals when required; changes in the Federal Reserve Board monetary policies; unexpected outcomes of new and existing litigation in which Blackhawk or its subsidiaries, officers, directors or employees is named defendants; technological changes; changes in accounting principles generally accepted in the United States; changes in assumptions or conditions affecting the application of critical accounting policies; and the inability of third party vendors to perform critical services for the company or its customers.

The Company does not undertake, and specifically declines any obligation, to publicly release the results of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

ACQUISITION OR DISPOSITION OF ASSETS

On September 30, 2003 (the "Effective Date"), Blackhawk Bancorp, Inc., (the "Corporation") consummated its acquisition of DunC Corp. ("DunC"), a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and DunC's wholly owned subsidiary, First Bank, bc ("First Bank"), an Illinois state bank.

The Corporation acquired DunC and First Bank pursuant to an Agreement and Plan of Merger dated as of March 17, 2003 (the "Merger Agreement"), between the Corporation, DunC Merger Corporation ("Merger Corp"), a wholly owned subsidiary of the Corporation, and DunC through a series of mergers.

Pursuant to the Merger Agreement, Merger Corp was merged with and into DunC at the close of business on the Effective Date, and DunC became a wholly owned subsidiary of the Corporation. The merger consideration was cash in the aggregate amount of $7,223,000, which was paid to former DunC shareholders. The price paid by the Corporation for the DunC common stock was arrived at through arms-length negotiations.

The terms of the merger of Merger Corp with and into DunC are described more fully in the Merger Agreement filed as Exhibit 2.1 to the Corporation's Form 10-QSB for the quarterly period ended June 30, 2003, which is incorporated herein by reference. The description of the transaction set forth above is qualified in its entirety by the terms set forth in the Merger Agreement.

Immediately following the merger of Merger Corp into DunC, DunC merged with and into the Corporation, and First Bank merged with and into Blackhawk State Bank, a wholly owned subsidiary of the Corporation. As a result of these mergers the Corporation and Blackhawk State Bank were the surviving entities, and DunC and First Bank ceased to exist.

The merger consideration paid to the former shareholders of DunC was funded through a term loan with U.S. Bank National Association, Milwaukee, Wisconsin. The term loan for $7.5 million was entered into in the ordinary course of business and on terms commensurate with prevailing market conditions on September 26, 2003. The term loan matures on September 26, 2008. A copy of the term loan agreement was filed as an exhibit on the Corporation's Current Report on Form 8-K dated September 30, 2003 and is incorporated herein by reference.

In accordance with the requirements of purchase accounting, the operations of the acquired companies have been included with the operations of the Company since date of acquisition. Because of the relative size of the Company and DunC, the acquisition has had a significant effect on both the operations and balance sheets of the Company, and significantly affects comparisons between 2003 and 2004. In addition, as part of that acquisition, the Company committed to its regulators to maintain the Bank's Tier 1 leverage capital at not less than 7% for three years, and to raise capital in the event that the cash flow required to service debt incurred in the acquisition exceeds 80% of Bank net income.

The following provides certain summary financial information about the financial condition of DunC and the assets and liabilities acquired in the acquisition, and DunC's operations, prior to the acquisition to illustrate their impact upon the corporation:

Balance Sheet

(Dollars in thousands)	At September 30, 2003
Loans	$46,781
Allowance for Loan Losses	(889)
Investments	11,104
Total Assets	77,726
Deposits	64,237
Borrowings	3,631

Income Statement

(Dollars in thousands)	Nine Months Ended September 30, 2003	Year Ended December 31, 2002
Total Interest Income	$ 3,645	$ 4,602
Total Interest Expense	850	1,453
Net Interest Income	2,795	3,149
Provision for Loan Losses	200	628
Non-Interest Income	1,819	2,497
Non-Interest Expense	4,701	4,208
Net Income (Loss) before Tax	(287)	810

On the acquisition date, the First Bank branch located at 417 Ware Avenue, Rockford, Illinois was closed with its accounts being consolidated into the Bank's Rockford office located at 2475 North Perryville Road. On January 31, 2004 the Bank closed its branch office located at 1021 North State Street, Belvidere, Illinois and consolidated the accounts into the office located at 2141 North State Street, Belvidere, Illinois, which is a former First Bank branch obtained in the acquisition.

On June 22, 2004 the Bank entered into an agreement to sell its Rochelle and Oregon, Illinois branches to The First National Bank and Trust Company of Rochelle, Illinois. The agreement was filed as exhibit 2.1 to Form 8-K dated June 22, 2004 and is incorporated herein by reference. The description of the transaction set forth below is qualified in its entirety by the terms set forth in the Agreement.

The purchaser will assume the deposits of these two locations and will acquire their premises and equipment. The Bank will transfer assets equal to the liabilities assumed net of a premium equal to 6.77% of Core Deposit Liabilities transferred. Currently these two branches have deposits of approximately $35 million. The Bank will retain the loans of these two branches.

The Bank plans to replace these deposits with brokered deposits, Federal Home Loan Bank borrowings, liquidation of investment securities, or some combination thereof. The transaction is subject to regulatory and other customary closing conditions and is expected to close in the fourth quarter of 2004.

In accordance with generally accepted accounting principals, the deposits to be transferred and the results of operations of these two branches are included in the company's June 30, 2004 and December 31, 2003 balance sheets and in its results of operations and cash flows for all periods presented.

RESULTS OF OPERATIONS

The company reported net income of $426,000 for the three months ended June 30, 2004, an increase of $96,000 or 29.1% from the $330,000 reported for the same three month period in 2003. Net income for the six month period ended June 30, 2004 was $832,000, an increase of $105,000, or 14.4% from the $727,000 reported for the same period in 2003.

Diluted earnings per share were $0.17 and $0.33 for the three and six months ended June 30, 2004, respectively, compared to $0.13 and $0.29 for the same periods in 2003. This represents an increase of 30.8% and 13.8% for the three month and six month periods, respectively.

NET INTEREST INCOME

Net interest income, which is the sum of interest and certain fees generated by earning assets minus interest paid on deposits and other funding sources, is the primary source of the company's earnings. All discussions of interest income amounts and rates are on a tax-equivalent basis, which accounts for income earned on loans and securities that are not fully subject to income taxes as if they were fully subject to income taxes. The following table sets forth the company's consolidated average balances of assets, liabilities and stockholders' equity, interest income and expense on related items, and the company's average rate for the three and six month periods ended June 30, 2004 and 2003. The tax-equivalent yield calculations assume a Federal Tax Rate of 34%:

AVERAGE BALANCE SHEET WITH RESULTANT INTEREST AND RATES

(yields on a tax-equivalent basis)	Three Months ended June 30, 2004			Three Months
	Average Balance	Interest	Average Rate	Average Balance
INTEREST EARNING ASSETS:				
Interest-bearing deposits in banks	$ 2,394	$ 13	2.18%	$ 1,409
Federal funds sold & securities purchased under agreements to resell	5,036	18	1.44%	1,640
Investment securities:				
Taxable investment securities	103,092	922	3.60%	99,804
Tax-exempt investment securities	32,241	464	5.79%	28,387
Total investment securities	135,333	1,386	4.12%	128,191
Loans	238,200	3,473	5.86%	182,962
TOTAL EARNING ASSETS	$380,963	$4,890	5.16%	$314,202
Allowance for loan losses	(3,124)			(2,278)
Cash and due from banks	13,539			11,263
Other assets	26,838			19,833
TOTAL ASSETS	$418,216			$343,020
INTEREST BEARING LIABILITIES:				
Interest bearing checking accounts	$ 46,277	$ 57	.50%	$ 39,047
Savings and money market deposits	82,659	157	.76%	54,466
Time deposits	134,869	862	2.57%	124,229

Total interest bearing deposits	263,805	1,076	1.64%	217,742
Short-term borrowings	11,791	23	.78%	13,463
Subordinated debentures	7,217	103	5.74%	7,217
Long-term borrowings	57,404	561	3.93%	44,029
TOTAL INTEREST-BEARING LIABILITIES	$340,217	$1,763	2.08%	$282,451
INTEREST RATE SPREAD			3.08%	
Checking accounts	50,211			32,535
Other liabilities	2,203			2,140
Total liabilities	392,631			317,126
Stockholders' equity	25,585			25,894
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$418,216			$343,020
NET INTEREST INCOME/MARGIN		$3,127	3.30%	

AVERAGE BALANCE SHEET WITH RESULTANT INTEREST AND RATES

(yields on a tax-equivalent basis)	Six Months ended June 30, 2004			Six Months
	Average Balance	Interest	Average Rate	Average Balance
INTEREST EARNING ASSETS:				
Interest-bearing deposits in banks	$ 2,621	$ 30	2.30%	$ 1,774
Federal funds sold & securities purchased under agreements to resell	4,511	31	1.38%	5,072
Investment securities:				
Taxable investment securities	102,568	1,978	3.88%	93,158
Tax-exempt investment securities	32,272	938	5.85%	26,692
Total investment securities	134,840	2,916	4.35%	119,850
Loans	237,899	7,015	5.93%	182,960
TOTAL EARNING ASSETS	$379,871	$9,992	5.29%	$309,656
Allowance for loan losses	(3,188)			(2,212)
Cash and due from banks	13,495			10,860
Other assets	27,280			19,930

TOTAL ASSETS	$417,458			$338,234
INTEREST BEARING LIABILITIES:				
Interest bearing checking accounts	$ 46,802	$ 125	.54%	$ 38,513
Savings and money market deposits	79,728	307	.77%	53,527
Time deposits	137,021	1,768	2.59%	123,518
Total interest bearing deposits	263,551	2,200	1.68%	215,558
Short-term borrowings	12,927	52	.81%	12,958
Subordinated debentures	7,217	206	5.74%	7,217
Long-term borrowings	56,932	1,121	3.96%	42,445
TOTAL INTEREST-BEARING LIABILITIES	$340,627	$3,579	2.11%	$278,178
INTEREST RATE SPREAD			3.18%	
Checking accounts	48,329			32,164
Other liabilities	2,658			2,011
Total liabilities	391,614			312,353
Stockholders' equity	25,844			25,881
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$417,458			$338,234
NET INTEREST INCOME/MARGIN		$6,413	3.39%	

Net interest income increased by $576,000, or 22.6%, to $3,127,000 for the quarter ended June 30, 2004, compared to $2,551,000 for the comparable period in 2003. On a year to date basis net interest income increased by $1,126,000, or 21.3%, to $6,413,000 compared to $5,287,000 for the first six months of 2003. The increase in net interest margin is primarily due to the DunC acquisition which added $69,300,000 of earning assets and $54,000,000 of interest bearing liabilities at the acquisition date of September 30, 2003.

The net interest margin, which is the tax equivalent net interest income divided by average interest earning assets was 3.30% and 3.39% for the three and six month periods ended June 30, 2004. The second quarter net interest margin represents a 4 basis point increase compared to the 2003 second quarter net interest margin of 3.26%. The year to date net interest margin of 3.39% represents a 5 basis point decrease compared to the 3.44% net interest margin realized for the same period in 2003. The increase in second quarter net interest margin reflects management's efforts to shift the earning asset mix from investments to loans and to shift the liability mix from time deposits to savings and demand deposits. These shifts offset the negative impact of asset re-pricings at interest rates that remain at 46 year historical lows.

For the three months ended June 30, 2004, total interest income increased by $454,000, or 10.2%, to $4,890,000 compared to $4,436,000 for the same period in 2003. The increase in interest income is due to an increase in average earning assets of 21.2% or $66,761,000 offset by a 50 basis point decrease in average yield on earning assets. The average balance sheet with resultant interest and rates reflects the earning assets of DunC for the first two quarters of 2004, but not the first two quarters of 2003, as the acquisition was completed on September 30, 2003. At September 30, 2003 DunC had earning assets of $69,300,000. Earning assets adjusted to reflect the DunC acquisition decreased $2,539,000 or 0.7% quarter over quarter.

For the six months ended June 30, 2004, total interest income increased by $930,000, or 10.3%, to $9,992,000 compared to $9,062,000 for the same period in 2003. The increase in interest income is due to an increase in average earning assets of 22.7% or $70,215,000 offset by a 61 basis point decrease in the yield on average earning assets to 5.29% compared to 5.90% for the same period in 2003. Earning assets for the six months ended June 30, 2004 adjusted to reflect the DunC acquisition increased $915,000 or 0.2%.

Managed and long-term interest rates remained at 46 year historical lows during the second quarter of 2004. On June 30, 2004 the Federal Reserve Board of Governors increased managed interest rates by 25 basis points. While management believes they have adequate systems and processes in place to manage interest rate risk, the pace and magnitude of interest rate changes could have an adverse impact on net interest income in the future.

Interest and fees on loans increased 13.3% to $3,473,000 for the three months ended June 30, 2004 compared to $3,065,000 for the same period of 2003. This increase was the result of a $55,238,000 or 30.2% increase in average loans outstanding offset by an 86 basis point decrease in yield on the portfolio. Interest and fees on loans increased 10.9% to $7,015,000 for the six months ended June 30, 2004 compared to $6,328,000 in same period of 2003. This increase was the result of a $54,939,000 or 30.0% increase in average loans outstanding and a 104 basis point decrease in yield on the portfolio. The Company acquired $46,781,000 of gross loans at September 30, 2003 in connection with the DunC acquisition. Excluding the loans obtained in the DunC acquisition, average total loans increased $8,457,000 or 3.7% for the three months ended June 30, 2004 and $8,158,000 or 3.6% for the six months ended June 30. 2004. The lower yield on average loans continues to reflect the overall lower interest rate environment previously discussed and continuing competitive pricing pressure for quality credit customers.

Interest income on taxable securities decreased by $7,000 or 0.8% in the second quarter of 2004 to $922,000 compared to $929,000 for the same period in 2003. Average balances of taxable investment securities increased 3.3% to $103,092,000 for the quarter ended June 30, 2004 compared to $99,804,000 for the same period in the prior year. The yield on average taxable investment securities decreased 13 basis points to 3.60% for the second quarter of 2004 compared to 3.73% for the second quarter of 2003. Tax exempt investment securities increased $3,854,000, or 13.6% to an average balance of $32,241,000 for the three months ended June 30, 2004 compared to $28,387,000 for the same period in 2003. Interest income on tax exempt securities increased $37,000 or 8.7% to $464,000 for the second quarter of 2004 compared to $427,000 for the second quarter of 2003. The DunC acquisition added $8,800,000 of taxable investment securities and $2,300,000 of tax-exempt investment securities at the acquisition date. Excluding the securities acquired in the DunC acquisition taxable investment securities decreased $5,512,000 or 5.1% and tax exempt investment securities increased $1,544,000 or 5.1%.

Interest income on taxable securities increased by $121,000, or 6.5%, in the first six months of 2004 to $1,978,000 from $1,857,000 for the same period in 2003. Average balances of taxable investment securities increased 10.1% to

$102,568,000 for the six months ended June 30, 2004 compared to $93,158,000 for the same period in the prior year. The increase in average balances outstanding was offset by a decrease of 14 basis points in average yield to 3.88% for the first six months of 2004 compared to 4.02% for the first six months of 2003. Average tax exempt securities increased to $32,272,000 for the six months ended June 30, 2004 compared to $26,692,000 for the same period in 2003 and their average tax equivalent yield decreased from 6.12% for the six months ended June 30, 2003 to 5.85% for the same period in 2004. The DunC acquisition added $8,800,000 of taxable investment securities and $2,300,000 of tax-exempt investment securities at the acquisition date. Excluding the securities acquired in the DunC acquisition taxable investment securities increased $610,000 or 0.6% and tax exempt investment securities increased $3,280,000 or 11.3%.

Interest from federal funds sold and securities purchased under agreements to resell increased to $18,000 for the three month period ended June 30, 2004, compared to $7,000 during the same period in 2003. The average balance of federal funds sold and securities purchased under agreements to resell increased by $3,396,000 or 207.1% to $5,036,000 for the three months ended June 30, 2004.

Interest from federal funds sold and securities purchased under agreements to resell decreased to $31,000 for the six month period ended June 30, 2004, compared to $49,000 during the same period in 2003. The average balance of federal funds sold and securities purchased under agreements to resell decreased by $561,000 or 11.1% to $4,511,000 for the six months ended June 30, 2004.

Total interest expense decreased by $122,000, or 6.5%, to $1,763,000 for the three months ended June 30, 2004 compared to $1,885,000 for the same period in 2003. For the six months ended June 30, 2004 total interest expense decreased by $196,000, or 5.2%, to $3,579,000 compared to $3,775,000 for the same period in 2003. The decrease in total interest expense is the result of the aforementioned lower interest rate environment which reduced the average rate paid on interest bearing liabilities from 2.67% for the three months ended June 30, 2003 to 2.08% for the three months ended June 30, 2004 and from 2.74% for the six months ended June 30, 2003 to 2.11% for the six months ended June 30, 2004. The DunC acquisition increased interest bearing liabilities by $54,000,000 at the acquisition date. Excluding the acquisition, interest bearing liabilities increased by $3,766,000 or 1.1% and by $8,449,000 or 2.5% for the three and six month periods ended June 30, 2004.

While interest paid on deposits decreased $154,000, or 12.5% to $1,076,000 during the three months ended June 30, 2004 compared to $1,230,000 for the same period in 2003, average interest bearing deposits increased $46,063,000, or 21.2% quarter over quarter. Year to date interest paid on deposits decreased $296,000, or 11.9% to $2,200,000 compared to $2,496,000 for the same period in 2003 while average total interest bearing deposits increased by $47,993,000, or 22.3%. The DunC acquisition added $50,300,000 in interest bearing deposits as of September 30, 2003. Excluding the acquisition, interest bearing deposits decreased $4,237,000 or 1.6% and $2,307,000 or 0.9% for the three and six month periods ended June 30, 2004. The decrease in interest paid on deposits was primarily due to the overall lower interest rate environment.

Interest on short-term borrowings decreased $18,000 to $23,000 for the three months ended June 30, 2004 compared to $41,000 for the same period in 2003. This decrease is the result of a $1,672,000 decrease in average balances outstanding for the three months ended June 30, 2004 compared to the same period in 2003 combined with the effect of the sustained low interest rate environment. For the six months ended June 30, 2004 interest on short-term borrowings decreased $24,000 to $52,000 compared to $76,000 for the same period in 2003. This decrease is the result of the sustained low interest rate environment and a $31,000 or 0.2% decrease in average short-term borrowings to $12,927,000 for the six months ended June 30, 2004 compared to $12,958,000 for the same period in 2003.

Interest expense on subordinated debentures increased by $19,000 to $103,000 for the second quarter of 2004 compared to $84,000 in the second quarter of 2003 and by $38,000 to $206,000 for the six months ended June 30, 2004 compared to $168,000 for the same period in 2003. The increase reflects the use of an interest rate swap, which was entered into by the company on June 26, 2003 to fix the cost of this borrowing. During the first six months of 2003 the interest rate adjusted quarterly and was set at 325 basis points over the 3 month LIBOR rate. The interest rate swap was part of the Company's overall interest rate risk management strategy and was utilized to minimize significant fluctuations in earnings caused by interest rate volatility.

Interest expense on long-term borrowings increased $31,000 and $86,000 to $561,000 and $1,121,000 for the three and six month periods ended June 30, 2004 compared to $530,000 for the second quarter and $1,035,000 for the first six months of 2003. The average balance outstanding increased $13,375,000 or 30.4% for the three months ended June 30, 2004 and $14,487,000 or 34.1% for the six months ended June 30, 2004. The increase in the average balance of long-term borrowings outstanding reflects the $7,500,000 in bank debt issued to finance the DunC acquisition and additional FHLB borrowings in 2004.

PROVISION FOR LOAN LOSSES

The provision for loan losses (provision) is an amount added to the allowance for loan losses (allowance) to provide for the known and estimated amount of loans that will not be collected. Actual loan losses are charged against the allowance when management believes that the collection of principal will not occur. Subsequent recoveries of amounts previously charged to the allowance, if any, are credited to (increase) the allowance. Management determines the appropriate provision based upon a number of criteria, including a detailed evaluation of certain credits, historical performance, economic conditions and overall quality of the loan portfolio.

The provision was $103,000 in the second quarter of 2004, a decrease of $39,000 or 27.5% from the $142,000 in the second quarter of 2003. For the first six months of 2004, the provision was $207,000 compared to $365,000 during the same time period a year ago.

Activity in the allowance for loan losses is detailed in Note 2 to the unaudited consolidated financial statements. Charge-offs, net of recoveries for the second quarter of 2004 totaled $768,000 compared to net recoveries of $3,000 for the second quarter of 2003. Year to date net charge-offs increased $899,000 or 881.4% to $1,001,000 compared to $102,000 for the first six months of 2003. During the second quarter of 2004 the bank recognized charge-offs totaling $668,000 on two commercial real estate loans. These loans were in non-performing status at December 31, 2003. The collateral on one of the loans has been liquidated and the other is held in other real estate at its estimated net realizable value at June 30, 2004. The charge-offs related to these two loans resulted in a decrease in the allowance to total loans to 1.07% at June 30, 2004 compared to 1.26% at June 30, 2003 and 1.41% at December 31, 2003. These loans had specific reserve allocations of $470,000 at December 31, 2003.

NONINTEREST INCOME

Total noninterest income increased $318,000, or 36.1%, to $1,200,000 for the three months ended June 30, 2004 compared to $882,000 for the same period in 2003. Year to date total noninterest income increased $306,000, or 15.9%, to $2,228,000 compared to $1,922,000 for the same period in 2003.

Service charges on deposit accounts increased $264,000 to $629,000 for the quarter ended June 30, 2004 compared to $365,000 for the second quarter of 2003, and increased $411,000 to $1,115,000 for the six months ended June 30, 2004 compared to the same period in 2003. These increases are due to the accounts obtained in the DunC acquisition and the introduction of an overdraft privilege program in the second quarter of 2004.

Gains on the sales of mortgage loans increased $67,000 or 47.5% to $208,000 for the second quarter of 2004 compared to the $141,000 of gains recognized during the second quarter of 2003. In the second quarter of 2004, $14,650,000 of loans were sold to the secondary market compared to $7,719,000 for the same period in 2003. Year to date gain on sale of mortgage loans increased $54,000 or 17.9% to $355,000 compared to $301,000 for the same period in 2003. The average gain in 2004 was 1.45% on $24,506,000 in loans sold to the secondary market compared to an average gain of 1.80% on the $16,708,000 of loans sold in the same period in 2003. At June 30, 2004 the pipeline of held for sale loans has decreased substantially from the level that existed at March 31, 2004. The decrease is due to a rise in market interest rates which has reduced the demand for mortgage refinancings and turnover in the mortgage origination staff. The decrease in the held for sale loan pipeline may negatively impact the gains on sales of mortgage loans realized in the next quarter.

The Company recognized $72,000 in securities gains in the second quarter of 2004 compared to $95,000 in the second quarter of 2003. Year to date the company has realized $152,000 in securities gains, a $272,000 or 64.2% decrease compared to the $424,000 in gains realized for the six months ended June 30, 2003. Securities are sold from time to time to reposition the portfolio into investments that offer better risk reward characteristics under a number of potential future interest rate scenarios.

Other noninterest income increased $16,000 or 7.8% to $220,000 for the quarter ended June 30, 2004 compared to $204,000 for the second quarter of 2003.

Year to date other noninterest income increased by $126,000 or 37.1% to $466,000 for the six months ended June 30, 2004 from $340,000 for the six months ended June 30, 2003.

NONINTEREST EXPENSES

Total noninterest expense increased $753,000, or 26.7%, to $3,568,000 for the three months ended June 30, 2004 compared to $2,815,000 for the same period in 2003. Year to date noninterest expense increased by $1,370,000, or 23.7% to $7,150,000 for the six months ended June 30, 2004 compared to $5,780,000 for the six months ended June 30, 2003. The increases reflect increased costs in 2004 as a result of the DunC acquisition offset by the accretive benefits from the elimination of duplicative expenses.

Salaries and employee benefits increased $477,000 or 35.1% to $1,837,000 for the quarter ended June 30, 2004 compared to $1,360,000 for the second quarter of 2003. For the first six months of 2003 total salaries and employee benefits increased $837,000 or 29.7% to $3,655,000 compared to $2,818,000 for the same period in 2003. The increases reflect additional staffing due to the DunC acquisition, additional costs of employee benefits and normal salary increases.

Equipment expenses increased $69,000 or 29.9% to $300,000 for the quarter ended June 30, 2004 compared to $231,000 for the same quarter in 2003. For the first six months of 2003 equipment expense increased $147,000, or 31.9%, to $608,000 compared to $461,000 for the same period in 2003. The increases relate primarily to increased depreciation and maintenance on assets acquired in the DunC acquisition and additional depreciation and maintenance on a new items processing system installed during the third quarter of 2003.

Data processing costs increased $69,000, or 34.0%, to $272,000 for the quarter ended June 30, 2004 and $151,000, or 37.8%, to $550,000 for the six months ended June 30, 2004. These increases reflect higher volumes of service utilized from our core processor due to additional accounts added in the DunC acquisition and the outsourcing of network support services in 2004.

Professional fees decreased $58,000 or 19.2%, to $244,000 for the six months ended June 30, 2004 compared to $302,000 for the same period in 2003 primarily as a result of lower legal fees in 2004 related to the Fiserv, Inc. litigation. There is an appeal in this case still pending and the Company may incur additional legal fees in future periods as more fully discussed under the heading "OFF BALANCE SHEET ITEMS AND CONTINGENCIES" in Part I Item 2 of this report.

Other noninterest expenses increased $49,000 or 19.0% to $307,000 for the three months ended June 30, 2004 compared to $258,000 for the same period a year ago. For the first six months of 2004 other noninterest expenses increased $13,000 or 2.2% to $596,000 compared to $583,000 for the same period in 2003. Other expenses for the quarter ended March 31, 2003 included a non-recurring expense of $56,000 related to a sales and use tax audit.

BALANCE SHEET ANALYSIS

OVERVIEW

Total assets decreased to $415,911,000 at June 30, 2004 compared to $425,402,000 at December 31, 2003, a decrease of 2.2%. The December 31, 2003 balance sheet included short-term year-end deposits of $11,750,000, which were invested in federal funds sold and interest bearing deposits in banks at December 31, 2003. Excluding these deposits, total assets increased $2,259,000, or 0.5% from December 31, 2003 to June 30, 2004.

LOANS

Net loans increased $1,581,000, or 0.7%, to $231,723,000 on June 30, 2004 compared to $230,142,000 on December 31, 2003. The composition of loans is shown in the following table:

	June 30, 2004	December 31, 2003	Change in Balance	As a % of Total Loans June 30, 2004	As a % of Total Loans December 31, 2003
	(Dollars in millions)				
Residential Real Estate	$99.9	$97.5	$2.4	42.7%	41.8%
Commercial Real Estate	$69.2	$67.0	$2.2	29.5%	28.7%
Construction and Land Development	$16.8	$11.3	$5.5	7.2%	4.8%
Commercial	$27.3	$35.6	($8.3)	11.7%	15.3%
Consumer	$18.6	$19.2	($0.6)	7.9%	8.2%
Other	$2.4	$2.8	($0.4)	1.0%	1.2%

During the second quarter of 2004 loans decreased by $7,312,000 due to principal amortization on outstanding loans, the pay-off of a $2,493,000 commercial relationship due to a sale of the customer's business and the partial charge off of two commercial relationships. Management intends to aggressively pursue quality credits in future periods and plans a consumer loan promotion.

NON-PERFORMING LOANS

Non-performing loans include loans that are determined by management to be impaired because full collection of interest and principal is doubtful, have been placed in non-accrual status, and accruing loans which are past-due ninety days or more as to interest and/or principal payments.

The following summarizes information concerning non-performing loans:

(Dollars in thousands)	JUNE 30, 2004	DECEMBER 31, 2003
Impaired loans-still accruing	$ 875	$ 923
Impaired loans-non-accrual	994	2,058
Other non-accrual	1,285	1,030
Past due 90 days or more and still accruing	515	42
Total non-performing loans	$3,669	$4,053

ASSET QUALITY

The allowance for loan losses was $2,508,000 or 1.07% of total loans at June 30, 2004 compared to $3,302,000 or 1.41% of total loans at December 31, 2003. As of June 30, 2004, non-performing loans totaled $3,669,000 compared to $4,053,000 at December 31, 2003. The decrease during the second quarter of 2004 is due to the resolution of two commercial loan relationships totaling $1,285,000. The collateral on one of the loan relationships has been liquidated and the collateral on the other loan relationship is held in other real estate at its estimated net realizable value at June 30, 2004. Management believes the allowance for loan losses is adequate at June 30, 2004.

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance for loan losses is adequate to cover probable credit losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. In accordance with FASB Statements 5 and 114, the allowance is provided for losses that have been incurred as of the balance sheet date. The allowance is based on past events and current economic conditions, and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. Management reviews a calculation of the allowance for loan losses on a quarterly basis. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions.

In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may require the bank to make additions to the allowance for loan losses based on their judgments of collectibility based on information available to them at the time of their examination. The policy of the Company is to place a loan on non-accrual status if: (a) payment in full of interest and principal is not expected, or (b) principal or interest has been in default for a period of 90 days or more, unless the obligation is both in the process of collection and well secured. Well secured is defined as collateral with sufficient market value to repay principal and all accrued interest. A debt is in the process of collection if collection of the debt is proceeding in due course either through legal action, including judgement enforcement procedures, or in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to current status.

At June 30, 2004 the allowance for loan losses to total non-performing and restructured loans equaled 68.4% compared to 81.5% at December 31, 2003.

SHORT-TERM INVESTMENTS

Federal funds sold and securities purchased under agreements to resell decreased $826,000 to $5,294,000 at June 30, 2004 compared to $6,120,000 at December 31, 2003.

Interest-bearing deposits in banks decreased $829,000 to $2,012,000 at June 30, 2004 compared to $2,841,000 at December 31, 2003.

INVESTMENT SECURITIES

During the second quarter of 2004 the Bank and it's Nevahawk subsidiary transferred $16,345,000 of securities in the held to maturity portfolio to the available for sale portfolio. The transfer allows for more flexibility in the management of the investment portfolio to increase total return. Investment securities decreased $6,129,000, or 4.5%, to $129,584,000 at June 30, 2004 compared to $135,713,000 at December 31, 2003. The decrease was used to fund the deposit decrease discussed below.

DEPOSITS

Total deposits decreased $16,913,000 to $306,726,000 at June 30, 2004 compared to $323,639,000 at December 31, 2003. As noted above, the Company's December 31, 2003 financial statements reflect short-term year-end deposits of $11,750,000. Excluding the short-term year-end deposits, total deposits decreased 1.7% from December 31, 2003. Excluding the short-term year-end deposits, non-interest bearing deposits increased by $1,191,000 and interest bearing deposits decreased by $6,354,000 at June 30, 2004 compared to December 31, 2003.

BORROWINGS

Short-term borrowings increased $7,401,000 to $16,887,000 at June 30, 2004 from $9,486,000 at year-end. The increase is due to higher outstanding balances of repurchase agreements with commercial customers.

Long-term borrowings consist of Blackhawk Bancorp's bank term loan of $7,500,000 and term advances from the Federal Home Loan Bank ("FHLB") that were $49,732,000 at June 30, 2004 compared to $48,413,000 at December 31, 2003. The increase reflects a net additional $1,350,000 in FHLB advances outstanding at June 30, 2004.

SHAREHOLDERS' EQUITY

Total shareholders' equity decreased $565,000 to $25,198,000 at June 30, 2004 compared to $25,763,000 at December 31, 2003. The decrease is due to the impact of changes in market interest rates on the value of the investment portfolio. Accumulated other comprehensive income decreased $970,000 to ($142,000) at June 30, 2004 from $828,000 at December 31, 2003. Accumulated other comprehensive income consists of two parts. The unrealized gains (losses) on available-for-sale securities net of tax decreased by $1,026,000 to a net loss of $345,000 at June 30, 2004 compared to a net gain of $681,000 at December 31, 2003. The unrealized gains on the Company's interest rate swap contract net of tax increased by $56,000 to $203,000 at June 30, 2004 compared to $147,000 at December 31, 2003. During the first six months of 2004 surplus increased by $27,000 from the sale of stock for stock options exercised. In addition the company declared two quarterly dividends of $0.09 per share on common stock, which totaled $454,000.

The Company is subject to certain regulatory capital requirements and continues to remain in compliance with the requirements. The following table shows the company's capital ratios and regulatory requirements.

	JUNE 30,	DECEMBER 31,	REGULATORY

	2004	2003	REQUIREMENTS
Total Capital (To Risk-Weighted Assets)	10.9%	10.9%	8.0%
Tier I Capital (To Risk-Weighted Assets)	9.9%	9.6%	4.0%
Tier I Capital (To Average Assets)	6.2%	6.0%	4.0%

The Company's subsidiary bank also meets regulatory capital requirements to be considered well capitalized.

ASSET/LIABILITY MANAGEMENT

Asset/liability management is the process of identifying, measuring and managing the risk to the Company's earnings and capital resulting from the movements in interest rates. It is the Company's objective to protect earnings and capital while achieving liquidity, profitability and strategic goals.

The Company focuses its measure of interest rate risk on the effect a shift in interest rates would have on earnings. Since not all assets or liabilities move at the same rate and at the same time, a determination must be made as to how each interest earning asset and each interest bearing liability adjusts with each change in the base rate. The Company develops, evaluates and amends its assumptions on an ongoing basis and analyzes its earnings exposure quarterly.

In addition to the effect on earnings, a quarterly evaluation is made to determine the change in the economic value of equity with various changes in interest rates. This determination indicates how much the value of the assets and the value of the liabilities change with a specified change in interest rates. The net difference between the economic values of the assets and liabilities results in an economic value of equity.

During June 2003, the Company entered into an interest rate SWAP agreement related to the subordinated debentures. This SWAP is utilized to manage variable interest rate exposure and is designated as a highly effective cash flow hedge. The differential to be paid or received on the SWAP agreement is accrued as interest rates change and is recognized over the life of the agreement in interest expense. The SWAP agreement expires in December 2007 and essentially fixes the rate to be paid at 5.72%. The notional amount is $7,000,000. Included in other comprehensive income is a gain of $308,000, less $105,000 of deferred income tax, relating to the fair market value of the SWAP agreement as of June 30, 2004. Risk management results for the period ended June 30, 2004 related to the balance sheet hedging of the subordinated debentures indicate that the hedge was 100% effective and that there was no component of the derivative instrument's gain or loss which was excluded from the assessment of hedge effectiveness.

LIQUIDITY

Liquidity, as it relates to the subsidiary bank, is a measure of its ability to fund loans and withdrawals of deposits in a cost-effective manner. The Bank's principal sources of funds are deposits, scheduled amortization and prepayment of loan principal, amortization, prepayment and maturity of investment securities, short-term borrowings and income from operations. Additional sources include purchasing fed funds, sale of securities, sale of loans, borrowing from both the Federal Reserve Bank and Federal Home Loan Bank, and dividends paid by Nevahawk, a wholly owned subsidiary of the Bank.

The liquidity needs of the Company generally consist of payment of dividends to its shareholders, payments of principal and interest on borrowed funds and subordinated debentures, and a limited amount of expenses. The sources of funds to provide this liquidity are issuance of capital stock and dividends from its subsidiary bank. Certain restrictions are imposed upon the Bank, which could limit its ability to pay dividends if it did not have net earnings or adequate capital in the future. The Company maintains adequate liquidity to pay its expenses.

The following table summarizes The Company's significant contractual obligations and other potential funding needs at June 30, 2004 (in thousands):

Time Deposits	Long-term debt(1)	Operating	Data Processing