BLACKHAWK BANCORP INC
Form 10KSB
March 29, 2004

U. S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

[X] ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2003

OR

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________

Commission file number 0-18599

BLACKHAWK BANCORP, INC.
(Name of small business issuer in its charter)

WISCONSIN	39-1659424
(State of Incorporation)	(IRS Employer ID No.)

400 Broad Street, Beloit, Wisconsin 53511
(Address of principal executive offices)

Issuer's Telephone Number (608) 364-8911

Securities Registered Under Section 12(b) of the Exchange Act:
NONE

Securities Registered Under Section 12(g) of the Exchange Act:
COMMON STOCK, $ .01 PAR VALUE

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 .

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [ ]

State issuer's revenues for its most recent fiscal year. $20,555,930

As of March 17, 2004, 2,526,145 shares of common stock were outstanding and the aggregate market value (based on the bid price at March 17, 2004) of the shares held by non-affiliates (excludes shares reported or beneficially owned by directors and officers - does not constitute an admission to affiliate status) was approximately $24,255,000.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Blackhawk Bancorp, Inc.' s definitive proxy statement for its Annual

Meeting of Stockholders, to be held on May 19, 2004, are incorporated by reference into Part III hereof.

Transitional Small Business Disclosure Format (check one): Yes [ ] No [X]

BLACKHAWK BANCORP, INC.

FORM 10-KSB - TABLE OF CONTENTS

PART I

ITEM 1. DESCRIPTION OF BUSINESS

GENERAL. Blackhawk Bancorp, Inc. (the "Company") was incorporated under the laws of the state of Wisconsin in November 1989. The Company owns and operates a subsidiary financial institution, Blackhawk State Bank ("Bank") headquartered in Beloit, Wisconsin and owns 100% of the common securities of Blackhawk Statutory Trust I, which was formed in December 2002 for the purpose of issuing Trust Preferred Securities.

On September 30, 2003 the Company acquired DunC Corp. and its wholly owned subsidiary, First Bank, bc in a transaction accounted for as a purchase. The Company paid cash consideration of $7.2 million for DunC Corp. Immediately thereafter, DunC Corp was merged with and in to the Company and First Bank, bc was merged with and in to the Bank. In accordance with the requirements of purchase accounting, the operations of the acquired companies have been included with the operations of the Company since October 1, 2003. In this document, unless we specifically otherwise indicate, when we refer to "DunC" we include both DunC Corp. and First Bank, bc together. See also Item 6. "Recent Acquisition."

The Bank is a Wisconsin-chartered commercial bank operating eleven free-standing branches, three of which are in Beloit, Wisconsin and eight are located in the following cities in Illinois: Belvidere (2), Capron (1), Machesney Park (1), Oregon (1), Rochelle (1), Rockford (1) and Roscoe (1). Bank management has begun a program to evaluate the location and profitability of branch locations and has consolidated its former Beloit Wal-Mart location with the Beloit East location in 2002 and its former Belvidere North State Street location with the Belvidere West location during January 2004. The Bank has three wholly-owned subsidiaries: Nevahawk Investment, Inc. ("Nevahawk"), an investment subsidiary located in Las Vegas, Nevada; RSL, Inc. ("RSL"), which in turn owns Midland Acceptance Corporation ("MAC"), both of which are substantially inactive; and First Financial Services, Inc. ("FFSI"), whose primary activity is ownership of the closed North State Street facility.

Through its eleven locations the Bank provides various consumer banking, business banking and related financial services. Consumer banking services to individuals include demand, savings and time deposits. Consumer lending services include installment loans, mortgage loans, overdraft protection, personal lines of credit and credit cards. The Bank also provides trust and investment services through a separate department of the bank and also through a third party marketing agreement with a full service brokerage company.

Business banking services, which are provided to small business, commercial and governmental organizations include commercial and commercial real estate lending, deposits, cash management and letters of credit.

The Bank's primary source of revenue is interest income and fees earned on its loans and investments, net of interest paid on deposits and borrowings. Other non-interest income consists of mortgage loan sale and servicing fees, deposit service charges, trust fees, retail non-deposit investment sales income, and investment securities gains or losses.

LENDING ACTIVITIES. A significant amount of the loans in the Bank's loan portfolio are secured by residential or commercial real estate. Most of the real estate securing mortgage loans is located within thirty minutes driving distance of the Bank's offices. Commercial loans are either collateralized by non-real estate assets or are unsecured and may have fixed or variable interest rates. Consumer and installment loans are generally secured by automobiles, boats, or second liens on real estate. The Bank also offers credit cards and home equity lines of credit. The Analysis of Loan Portfolio, located in the discussion of "Loans" under Item 6 of this report, shows the changes in the types of loans from 2001 through 2003.

INVESTMENT ACTIVITIES. The Bank and its subsidiary, Nevahawk, each maintain investment portfolios, which are separately managed to provide liquidity for lending or deposit withdrawals, control interest rate risk and enhance earnings. The investments held by the Bank and Nevahawk consist primarily of U.S.

government and agency securities, mutual funds, corporate bonds, mortgage-backed securities, collateralized mortgage obligations and municipal bonds or repurchase agreements backed by similar securities. The Bank's investment portfolio is managed to maintain the Bank's need for liquidity; next to generate an acceptable level of interest income from the investment portfolio; and finally to maintain the interest rate sensitivity of the Bank's net interest income at desired levels. The investment portfolio of Nevahawk is managed to generate an acceptable level of interest income; next to maintain the interest rate sensitivity of the consolidated Bank's net interest income; and finally to maintain the parent Bank's need for liquidity. As more fully discussed in Item 6 of this report, the Wisconsin Department of Revenue has instituted an audit program specifically aimed at Nevahawk. The Department may take the position that the income of Nevahawk is taxable in Wisconsin which could result in a substantial negative impact on the earnings of the Company.

DEPOSIT ACTIVITIES. Deposits are divided between interest bearing and non-interest bearing. Non-interest bearing deposits consist of checking accounts of individuals, businesses and governmental organizations. The interest-bearing deposits include savings accounts, money market deposit accounts, certificates of deposit, individual retirement accounts and NOW accounts. The aggregate balance of time deposits with balances in excess of $0.1 million was $41.1 million at December 31, 2003.

WEALTH MANAGEMENT SERVICES. The Bank provides wealth management services, including acting as trustee for living and testamentary trusts, and as an agent, custodian, guardian, conservator, personal representative or administrator for individuals or their estates. The Bank also provides retail investment and insurance products through a third-party marketing agreement with Raymond James Financial Services, Inc. During the first quarter of 2004, the Bank began offering the trust services of Raymond James Trust Company through this third-party marketing agreement, and began transitioning internally administered trust accounts to products and services offered through Raymond James Financial Services, Inc. and Raymond James Trust Company.

COMPETITION. Active competition exists for all services offered by the Company with other state banks, national banks, credit unions, savings and loans, finance companies, personal loan companies, brokerage and mutual fund companies, mortgage bankers, insurance agencies, and other financial institutions in the Company's markets. The principal competitive factors in the banking and financial services industry are quality of services to customers, ease of access to services, and pricing of services, including interest rates paid on deposits, interest rates charged on loans, and fees charged for fiduciary and other services. To compete in this environment, the Company endeavors to offer competitive rates and fees, convenient hours and locations, and high quality services, including internet banking and a unique courier service.

EMPLOYMENT. As of December 31, 2003, the Company and the Bank had 186 employees, of which 149 were employed on a full-time basis. The Company provides a variety of benefit plans to its employees, including health insurance, long-term disability insurance, group term life insurance, flexible spending accounts, profit sharing, 401k, and stock options. Management considers its relations with employees to be good.

REGULATORY FILINGS WITH SECURITIES AND EXCHANGE COMMISSION. Copies of our Annual Reports on Form 10-KSB, Quarterly Reports on Form 10-QSB, Current Reports on Form 8-K, and amendments to those reports are available free of charge at the SEC's website at http://www.sec.gov and/or from the Company. They can be obtained at our website, http://www.blackhawkbank.com, through a link to the SEC website under "Shareholder Information" located at the bottom of the "Bank" page.

SUPERVISION AND REGULATION. The Company and the Bank are extensively regulated under federal and state law. Any descriptions of statutory and regulatory provisions contained in the following discussion are qualified in their entirety by reference to the particular statutory and regulatory provisions. Any change in applicable law or regulations may have a material effect on the Company.

THE COMPANY.
The Company is registered as a bank holding company with the Federal Reserve Board (the "FRB") under the Bank Holding Company Act of 1956, as amended (the "BHC Act"), and in that capacity acquired all of the capital stock of the Bank. As a result, since formation of the bank holding company in 1990, the Company's activities have been subject to limitations imposed under the BHC Act. Transactions between the Company and the Bank and their affiliates are also subject to certain restrictions. As a registered bank holding company, the Company is subject to various filing requirements of the FRB and is also subject to examination by the FRB.

FRB approval must be obtained before a bank holding company acquires all or substantially all of the assets of a bank or savings association or merges or consolidates with another bank holding company or savings and loan holding company. Under the BHC Act, we must obtain approval of the Federal Reserve Board to acquire another bank or bank holding company. The Federal Reserve Board may impose substantive conditions on any such acquisition. We obtained the approval of the Federal Reserve Board to acquire DunC in 2003. In connection with that acquisition, we agreed to maintain the Bank's tier I capital to average assets ratio at a minimum of 7.0% through September 30, 2006.

GRAMM-LEACH-BLILEY ACT. The laws and regulations to which the Company is subject are constantly under review by Congress, regulatory agencies and state legislatures. In 1999 important legislation was passed by Congress to overturn Depression-era restrictions on affiliations by banking organizations. This comprehensive legislation, referred to as the Gramm-Leach-Bliley Act (the "Act"), eliminates certain barriers to and restrictions on affiliations between banks and securities firms, insurance companies and other financial service organizations. The Act provides for a new type of "financial holding company" structure, under which affiliations among these entities may occur, subject to the regulation of the Federal Reserve Board and regulation of affiliates by the functional regulators, including the Securities and Exchange Commission and state insurance regulators. In addition, the Act permits certain non-banking financial and financially related activities to be conducted by operating subsidiaries of a national bank. Under the Act, a bank holding company may become certified as a financial holding company by filing a notice with the Federal Reserve Board, together with a certification that the bank holding company meets certain criteria, including capital, management and Community Reinvestment Act requirements. The Act contains a number of provisions allocating regulatory authority among the Federal Reserve Board, other banking regulators, the Securities and Exchange Commission and state insurance regulators. In addition, the Act imposes strict new limits on the transfer and use by financial institutions of nonpublic, personal information about their customers.

Other important provisions of the Act permit merchant banking activities, venture capital activities, and insurance underwriting, to be conducted by a subsidiary of a financial holding company. It also allows municipal securities underwriting activities to be conducted directly by a national bank or by its subsidiary. Under the Act, a financial holding company may engage in a broad list of "financial activities," and any non-financial activity that the Federal Reserve Board determines is "complementary" to a financial activity and poses no substantial risk to the safety and soundness of the depository institution or the financial system. The Company has not elected to become a financial holding company.

On June 1, 2000, the federal bank regulatory agencies issued final regulations implementing the Act's consumer privacy protections. Among other things, the new privacy regulations give customers the right to "opt out" of having their nonpublic, personal information shared by a financial institution with nonaffiliated third parties, bars financial institutions from disclosing customer account numbers or other such access codes to nonaffiliated third parties for direct marketing purposes and requires annual disclosure by financial institutions of their policies and procedures for protecting customers' nonpublic, personal information. Full compliance with the new privacy regulations was mandatory as of July 1, 2001.

USA PATRIOT ACT OF 2001. The USA Patriot Act of 2001 was adopted in 2001. The requirements of the Act went into effect in October 2002, upon issuance of final rules, although certain provisions of the USA Patriot Act are subject to review, expiration or renewal beginning in 2004. This comprehensive legislation provides that U.S. depository institutions are prohibited from providing correspondent banking services to foreign shell banks. It also requires that upon request of the appropriate federal banking agency the Bank must produce records relating to its anti-money laundering compliance or its customers within 120 hours of the request. The Act allows the Bank to share information relating to money laundering or suspected terrorists with the Financial Crimes Enforcement Network (FinCEN) and other financial institutions. In addition, the Act requires the institution to establish anti-money laundering programs and perform due diligence on private banking and correspondent accounts. The Act allows the Treasury to issue regulations on the maintenance of "concentration accounts" and to prohibit an institution's customers from anonymously directing funds into or through such accounts. The Federal Reserve Board and other regulators are required to consider the effectiveness of a bank holding company or its financial institution in combating money laundering when ruling on applications.

Section 326 of the USA Patriot Act of 2001 requires the Bank to develop an extensive Customer Identification Program and obtain certain information prior to opening or adding a signatory to an account. The Bank must adopt risk-based procedures for verifying the elements of customer information and must develop procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations provided to the institution by any federal government agency. The Bank must provide the customer prior notice of the requirements of the Act, and must retain all records used to verify the customer's identity for a period of five years after the account is closed.

SARBANES-OXLEY ACT OF 2002. 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.

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.

The Act requires audit committees to have in place procedures to receive and address complaints regarding accounting, internal control and auditing issues and provides protection for corporate whistleblowers. The Company has adopted a policy providing employees with the opportunity to confidentially report their concerns directly to members of the Bank's Audit Committee or the Bank's Internal Auditor and has communicated its policy to all employees.

CAPITAL ADEQUACY. The FRB has adopted capital guidelines as to both minimum levels of core capital and risk-based capital. The minimum core capital requirement ranges from 3% to 5% of total assets depending upon the regulator's determination of the holding company's strength. The guidelines assign risk weightings to assets and off-balance sheet items, and have minimum risk-based capital ratios. All bank holding companies are required to have total consolidated capital of 8% of risk-weighted assets. Core capital consists principally of shareholders' equity less intangibles, while qualifying total capital consists of core capital plus certain debt instruments and a portion of the allowance for loan losses. The discussion of "Capital" under Item 6 of this report reflects various regulatory measures of capital as of December 31, 2003. The Company's core and risk-based capital ratios, as shown, are well above the minimum levels.

Under Wisconsin law, a bank holding company is deemed to be engaged in the banking business and is subject to supervision and examination by the Wisconsin Department of Financial Institutions (the "WDFI"). The WDFI is also empowered to issue orders to a bank holding company to remedy any condition or policy, which, in the opinion of the WDFI, endangers the safety of deposits of any subsidiary state bank or trust company. In the event of non-compliance with such an order, the WDFI has the power to direct the operations of the state bank or trust company and to restrict dividends paid to the bank holding company.

THE BANK.
Wisconsin-chartered banks, including the Bank, are regulated and supervised by the WDFI. Each Wisconsin chartered bank is periodically examined by the WDFI or its primary federal regulator. The approval of the WDFI is required to establish or close branches, merge with other banks and undertake many other activities.

Any Wisconsin bank that does not operate in accordance with the regulations, policies and directives of the WDFI may be subject to sanctions for noncompliance. The WDFI may, under certain circumstances, suspend or remove directors, officers or employees who have violated the law, conducted the Bank's business in a manner which is unsafe, unsound or contrary to the depositors' interests or been negligent in the performance of their duties.

Wisconsin state banks are authorized to accept deposits (including demand, savings and time deposits and certificates of deposit). Banks may make a wide variety of loans (including mortgage loans, loans to corporations and other commercial loans and other personal consumer loans). Other federal and state regulations with respect to banks include required reserves, limitations as to the nature and amount, by type and borrower, of lending, regulatory approval of mergers and consolidations, issuance and retirement by a bank of its own securities, and other aspects of banking operations.

In 2003 the Wisconsin legislature enacted legislation allowing certain Wisconsin financial institutions to be certified as "universal banks" and exercise expanded powers. The Bank has not applied to the Wisconsin Division of Banking to be certified as a "universal bank."

PAYMENT OF DIVIDENDS. The Board of Directors of a Wisconsin bank may declare and pay a dividend from its undivided profits in an amount they consider expedient. The board of directors shall provide for the payment of all expenses, losses, required reserves, taxes, and interest accrued or due from the bank before the declaration of dividends from undivided profits. If dividends declared and paid in either of the two immediately preceding years exceeded net income for either of those two years respectively, the bank may not declare or pay any dividend in the current year that exceeds year-to-date net income except with the written consent of the WDFI. Federal and state regulations limit dividends paid by the Bank to the Company to net income of the Bank. The Bank paid dividends to the Company of $1.4 million, $1.5 million and $1.5 million for the years ended December 31, 2003, 2002 and 2001, respectively. During 2001 the

Bank received a waiver from the WDFI to pay dividends to the Company in excess of current net income.

FEDERAL DEPOSIT INSURANCE CORPORATION. The Bank's deposit accounts are insured by the FDIC. FDIC insurance, at the present time, generally insures up to a maximum of $0.1 million for each insured depositor. The FDIC imposes an annual assessment on deposits. Effective since 1993, premiums have been assessed on the basis of a risk rating assigned by the FDIC. Since that time the Bank's premium has been at the lowest available rate.

The FDIC issues regulations, conducts periodic examinations, requires the filing of reports and generally supervises the operations of its insured banks. The approval of the FDIC is required prior to any merger or consolidation, or the establishment or relocation of any branch office. This supervision and regulation is intended primarily for the protection of depositors.

As an FDIC-insured bank, the Bank is subject to certain FDIC requirements designed to maintain the safety and soundness of individual banks and the banking system. The FDIC, based upon appraisals during examinations, may revalue assets of an insured institution and require establishment of specific reserves in amounts equal to the difference between such revaluation and the book value of the assets. In addition, the FDIC has adopted regulations regarding capital adequacy requirements similar to those of the FRB.

OTHER ASPECTS OF FEDERAL AND STATE LAW. The Bank is also subject to federal and state statutory and regulatory provisions covering, among other things, security procedures, currency reporting, insider and affiliated party transactions, management interlocks, community reinvestment, truth-in-lending, electronic funds transfers, truth-in-savings, privacy, and equal credit opportunity.

Proposals for new legislation or rule making affecting the financial services industry are continuously being advanced and considered at both the national and state levels. Proposals are primarily focused upon restructuring and strengthening regulation and supervision to reduce the risks to which assets of banks and savings institutions are exposed.

In addition, changes in Wisconsin and Illinois state taxation can affect the Bank and the Company. See Item 6, "Management's Discussion and Analysis, Results of Operations--Income Tax" for a discussion of recent Wisconsin Department of Revenue activity and interpretations which could affect our Wisconsin state taxes.

Although further changes in the regulatory framework may be enacted, specific provisions and their ultimate effect upon the business of the Bank and the Company cannot be reliably anticipated.

GOVERNMENTAL MONETARY POLICIES AND ECONOMIC CONDITIONS. The earnings of the Bank and the Company are affected not only by general economic conditions but also by the policies of various governmental regulatory authorities. In particular, the FRB influences general economic conditions and interest rates through the regulation of money and credit conditions. It does so primarily through open-market operations in U.S. Government Securities, varying the discount rate on member and nonmember bank borrowings, and setting reserve requirements against bank deposits. FRB monetary policies have had a significant effect on the operating results of banks in the past and are likely to continue to have such an effect in the future. The general effect, if any, of such policies upon the future business and earnings of the Bank cannot be accurately predicted. In addition, losses sustained by the federal insurance funds and regulatory costs incurred in connection with failed or failing insured depository institutions continue to be assessed to those within the industry. As such, future earnings will be adversely affected by regulations enacted to cover these losses and costs.

ITEM 2. DESCRIPTION OF PROPERTY

On February 1, 2004, the Company had eleven locations, of which three were leased. All of these offices are considered by management to be well maintained and adequate for the purpose intended. The former branch property at 1021 North State Street in Belvidere was held for sale. Management feels all properties are adequately insured against loss. The Company's eleven locations are:

LOCATIONS

Address	Owned or Leased	Address	Owned or Leased
400 Broad St., Beloit, WI 53511	Owned	2141 N. State St., Belvidere, IL 61108	Leased
2200 Cranston Rd., Beloit, WI 53511	Owned	121 E. Locust Ave., Belvidere, IL 61008	Leased
1795 Madison Rd., Beloit, WI 53511	Owned	422 Cherry Ave., Rochelle, IL 61068	Owned
5206 Elevator Rd., Roscoe, IL 61073	Leased	307 N. Franklin Dr., Oregon, IL 61061	Owned
9609 Forest Hills Road, Machesney Park, IL 61115	Owned	209 W Main Street, Capron, IL 61012	Owned
2475 N. Perryville Road, Rockford, IL 61107	Owned		

See Note 6 to the Consolidated Financial Statements for further information on properties.

ITEM 3. LEGAL PROCEEDINGS

Management believes that no litigation is threatened or pending in which the Company faces potential loss or exposure which will materially affect the Company's financial position or results of operation, other than noted below. Since the Company's banking subsidiary acts as a depository of funds, trustee or escrow agent, it is named as defendant in lawsuits involving claims to the ownership of funds in particular accounts. This and other litigation is incidental to the Company's business.

In 2000 the Bank filed a lawsuit in Waukesha County, Wisconsin, against Fiserv, Inc., a former data processing services provider, for breach of contract. The bank was seeking to recover damages sustained due to a processing error in which $0.5 million was improperly charged to the Bank's check clearing account at the Federal Home Loan Bank of Chicago. On February 14, 2003 a jury delivered a verdict that Fiserv, Inc. did not breach its contract with the Bank. Fiserv, Inc. also filed a counterclaim seeking a $0.4 million reimbursement of legal fees. On May 12, 2003 a judge in the case denied Fiserv's motion for reimbursement of legal fees. In July, Fiserv appealed the trial court's denial of its request to have its legal fees reimbursed. The Bank thereafter cross-appealed on several grounds, including the trial court's denial of its motion for a new trial. Fiserv filed a motion to dismiss the Bank's cross-appeal on procedural grounds. This motion was denied and the appeal and cross-appeal are currently pending. The Company plans to aggressively contest Fiserv's appeal of the decision on legal fees and has not accrued the legal fee reimbursement claimed by Fiserv. The Bank also intends to aggressively pursue its appeal for a new trial. Although the ultimate disposition of any appeal can not be predicted with any certainty, the Company believes that the outcome of the case will not have a material adverse effect on the Company's consolidated financial position, though an adverse result could have a material adverse effect on the Company's consolidated results of operations in a given year.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2003.

EXECUTIVE OFFICERS

NAME AND AGE	PRINCIPAL OCCUPATION
R. Richard Bastian, III, 57	President and Chief Executive Officer of the Company since February 2002 and of the Bank since May 2001. Previously, President of the Bank of Kenosha from January 1999 to January 2001 and Executive Vice President and Director of the Clean Air Action Corporation from August 1994 to January 2000.
Todd J. James, 40	Executive Vice President and Chief Financial Officer of the Company and the Bank since February 2003. Senior Vice President and Chief Financial Officer from February 2002 to February 2003. Previously Senior Vice President, Amcore Investment Group N.A. from October 1999 to February 2002 and Vice President Amcore Financial, Inc. from October 1998 to October 1999.
Todd L. Larson, 44	Senior Vice President, Business Banking for the Bank since January 2003. Previously Vice President, Business Banking for the Bank from November 1999 to January 2003, and Vice President of Stillman BancCorp, N.A. from November 1998 to November 1999.
Terri L. Burdick, 40	Senior Vice President, Human Resources of the Bank since February 2003. Vice President, Human Resources of the Bank from October 2001 to February 2003. Employee Benefits Manager for The Swiss Colony, Inc. from September 1999 to October 2001. Previously, Corporate Benefits Manager for Regal Beloit Corporation.
Peggy G. Holt, 46	Senior Vice President Operations/Technology of the Bank since October 2003. Previously, Vice President, Quality Control & Process Improvement of the Bank from January 2003 until October 2003. Self-employed Organizational Effectiveness Consultant from January 2002 until December 2002. Prior thereto, Senior Consultant, Leadership Development and Senior Vice President, Organizational Development of Bank One Corporation.

Victoria A. Damron, 54	Vice President of Marketing for the Bank since August 2002. Previously owner Damron Communications.
Dale L. Blachford, 49	Senior Vice President-Business Banking of the Bank since October 2003. Previously President and Director of First Bank, bc.

PART II

ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES.

At December 31, 2003 the Company had approximately 900 holders of its common stock. Of the 2,522,995 shares then outstanding, 1,202,215 are held in street name by approximately 560 shareholders. The remaining 1,320,780 shares are issued directly with the Company's transfer agent in book entry or certificate form and are held by 336 shareholders of record. The Company's stock is publicly traded on the Over the Counter Market under the symbol BKHB. The following table sets forth the stock price and dividend information for each quarter during the years ended December 31, 2003 and 2002. Stock price information represents high and low asked and bid quotations and as such reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

	For the Quarter Ended							
	12/31/03	09/30/03	06/30/03	03/31/03	12/31/02	09/30/02	06/30/02	03/3
Stock Price:								
High	$12.35	$11.95	$12.00	$10.10	$10.00	$9.75	$10.25	$10
Low	11.75	11.25	9.15	9.10	8.25	8.55	9.35	9
Dividends	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0

For disclosures required under the Company's equity compensation plans, see Notes 1 and 11 to the Company's Consolidated Financial Statements attached as Exhibit 99.1 of this Form 10-KSB.

The Company does not have a formal dividend policy. The Company currently pays a quarterly dividend. To determine the actual amount of dividends, however, the Board must be mindful of regulatory and contractual limits on the payment of dividends by the Bank and the Company. For example, under the agreements relating to the Company's trust-preferred securities, if the Company shall have given notice of its election to defer payments of interest on the Company's trust preferred securities or if an Event of Default shall have occurred, the Company shall not, and shall not allow any Affiliate of the Company to declare or pay any dividends or distribution on, or redeem, purchase, acquire, or make a liquidation payment with respect to, any of the Company's capital stock or its Affiliates' capital stock (other than payments of dividends or distributions to the Company). In addition, the Bank and the Company are subject to regulatory capital requirements. In connection with the DunC acquisition, the Company further committed, for a period of three years after the acquisition, to maintain the Bank's Tier 1 leverage capital ratio at not less than 7%. In addition, the Company made assurances to Federal Regulators that if a dividend rate of 80% of the Banks earnings was insufficient to meet debt service requirements, the Company will fund the debt service with additional capital. The capital may come from, among other things, a reduction or elimination of shareholder dividends or from the issuance of capital securities.

ITEM 6. 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. This discussion focuses on the significant factors which affected the Company's earnings in 2003, with comparisons to 2002 and 2001, where applicable.

FACTORS INFLUENCING FORWARD-LOOKING STATEMENTS

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. Forward-looking statements speak only as of the date they are made, and Blackhawk undertakes no obligation to update publicly any of them in light of new information or future events.

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 are 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.

CRITICAL ACCOUNTING POLICIES

The financial condition and results of operations for Blackhawk Bancorp, Inc. presented in the Consolidated Financial Statements, accompanying notes to the Consolidated Financial Statements, selected financial data appearing elsewhere within this report, and management's discussion and analysis are, to a large extent, dependent upon the Company's accounting policies. The selection and application of these accounting policies involve judgements, estimates and uncertainties that are susceptible to change.

Presented below are discussions of those accounting policies that management believes are the most important (Critical Accounting Policies) to the portrayal and understanding of the Company's financial condition and results of operations. These Critical Accounting Policies require management's most difficult, subjective and complex judgements about matters that are inherently uncertain. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of materially different financial condition or results of operations is a reasonable likelihood. See also Note 1 of the Notes to Consolidated Financial Statements.

LOANS

Loans are the Company's largest income earning asset category. Loans are recorded at the amount advanced to the borrower plus certain costs incurred by the Bank to originate the loan, less certain origination fees that are collected from the borrower. The carrying amount of loans is reduced as principal payments are made. Payments made by the borrower are allocated between interest income and principal payment based upon the outstanding principal amount, the contractual rate of interest and other contractual terms. The carrying amount is further adjusted to reflect amortization of the origination costs net of origination fees. These items are amortized over the expected life of the loan.

The accrual of interest income is generally discontinued (Non-Accrual Status) when management believes that collection of principal and/or interest is doubtful or when payment becomes 90 days past due. Payments received from the borrower after a loan is placed on Non-Accrual Status are applied to reduce the principal balance of the loan until such time that collectibility of remaining principal and interest is no longer doubtful. Unpaid interest that has previously been recorded as income is reversed against interest income when a loan is placed on Non-Accrual Status. The outstanding loan balance is written-off against the allowance for loan losses when management determines that probability of collection of principal will not occur. See also the discussion of Allowance for Loan Losses that follows.

Those judgements and assumptions that are most critical to the application of this accounting policy are the initial and on-going credit-worthiness of the borrower, the amount and timing of future cash flows of the borrower that are available for repayment of the loan, the sufficiency of underlying collateral and the enforceability of third-party guarantees. These judgements and assumptions are dependent upon or can be influenced by a variety of factors including the breadth and depth of experience of lending officers, credit administration and loan review staff that periodically review the status of the loan, changing economic and industry conditions, changes in the financial condition of the borrower and changes in the value and availability of the underlying collateral and guarantees.

If different assumptions or conditions were to prevail, the amount and timing of interest income and loan losses, due to the inability to collect all of the remaining principal balance that is due from a borrower, could be materially different. These factors are most pronounced during economic downturns. See also the discussion of "Loans" contained in this Item and Note 5 of the Notes to Consolidated Financial Statements.

ALLOWANCE FOR LOAN LOSSES

Management periodically reviews the loan portfolio in order to establish an estimated allowance for loan losses (Allowance) that are probable as of the respective reporting date. Additions to the Allowance are charged against earnings for the period as a provision for loan losses (Provision). Actual loan losses are charged against (reduce) the Allowance when management believes that the collection of principal will not occur. Unpaid interest for loans that are placed on Non-Accrual Status is reversed against the interest income previously recognized. Subsequent recoveries of amounts previously charged to the Allowance, if any, are credited to (increase) the Allowance.

The Allowance is regularly reviewed by management to determine whether or not the amount is considered adequate to absorb probable losses. The Bank's policy considers the Allowance to be adequate within a range of 5% under or 10% over management's calculation of the required allowance. If not, an additional

Provision is made to increase the Allowance. This evaluation includes specific loss estimates on certain individually reviewed loans, statistical loss estimates for loan groups or pools that are based on historical loss experience and general loss estimates that are based upon the size, quality, and concentration characteristics of the various loan portfolios, adverse situations that may affect a borrower's ability to repay, and current economic and industry conditions.

In addition to the judgements and assumptions noted in the preceding discussion of Loans, those most critical to the application of this accounting policy are the frequency and subjectivity of loan reviews and risk gradings, emerging or changing trends that might not be fully captured in the historical loss experience, and charges against the Allowance for actual losses that are greater than previously estimated. While the Company strives to reflect all known risk factors in its evaluation of the adequacy of the Allowance, estimation or judgement errors may occur.

If different assumptions or conditions were to prevail, the Allowance may not be adequate to absorb the new estimate of probable losses. If so, an additional Provision may be necessary and the amount could be material. See also the discussion of "Loans" contained in this Item and Note 5 of the Notes to Consolidated Financial Statements.

RECENT ACQUISITION

On September 30, 2003, the Company acquired DunC Corp. and its wholly-owned subsidiary, First Bank, bc (referred to together as "DunC") in a transaction accounted for using the purchase method of accounting. 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 2002 and 2003. 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

RESULTS OF OPERATIONS

OVERVIEW

The Company reported net income of $1.2 million for the year ended December 31, 2003. This compares to $1.2 million for the year ended December 31, 2002 and $0.9 million for the year ended December 31, 2001. This represents no increase when comparing 2003 to 2002, and an increase of $0.3 million when comparing 2002 to 2001. The Company dedicated substantial resources during the second half of 2003 to the successful integration of the DunC acquisition. This produced a significant drag on short term earnings, including direct expenses incurred of approximately $0.1 million, and the opportunity cost of management and line staff time dedicated to the effort. The integration is substantially complete. This overview section, along with the above information on the recent acquisition, provides some of the highlights of the Company's operations in 2003. It is only a summary. We urge you to read the more complete discussions and analysis of that information in the balance of "Results of Operations."

Diluted earnings per share for 2003 were $0.48 compared to $0.50 in 2002 and $0.36 in 2001. This represents a decrease of $0.02 per share or 4.00% when comparing 2003 to 2002, and an increase of $0.14 per share when comparing 2002 to 2001. Diluted earnings per share for 2003 reflects a 2.02% increase in the weighted average common shares outstanding, resulting from the issuance of shares for stock options exercised.

SELECTED FINANCIAL RATIOS

	2003	2002	2001	2000	1999
Return on average assets	0.33%	0.38%	0.27%	(0.09)%	0.39%
Return on average equity	4.69%	4.92%	3.65%	(1.19)%	4.64%
Average equity to average assets	7.14%	7.79%	7.42%	7.78%	7.43%
Dividend payout ratio	74.90%	72.41%	114.58%	n/m	100.18%
Interest rate spread	3.04%	3.42%	3.23%	3.01%	3.15%
Net interest margin	3.30%	3.77%	3.66%	3.48%	3.64%
Net noninterest expense to assets	2.33%	2.56%	2.52%	2.57%	2.54%
Efficiency ratio	86.60%	81.61%	82.04%	86.23%	81.66%
Allowance for loan losses to total loans at end of period	1.41%	1.10%	1.14%	1.79%	1.04%

The Company's return on average equity for 2003 was 4.69% versus 4.92% in 2002 and 3.65% in 2001. The Company's return on average assets for 2003 was 0.33% compared to 0.38% in 2002 and 0.27% in 2001.

Both the Company and the Bank continue to exceed the minimum capital requirements established by regulators for banks and bank holding companies. In addition, the Bank continues to be "well capitalized" as defined by regulatory guidelines. See Note 17 to the Consolidated Financial Statements attached as Exhibit 99.1 to this Form 10-KSB.

In 2002 the Bank invested $5.0 million in Bank Owned Life Insurance. This redeployment of Bank assets shifted income from net interest income to other noninterest income, and had the effect of increasing cash surrender value earnings by $0.2 million year over year with an offsetting reduction in net interest income.

The 2002 results include the write-off of a $0.3 million receivable related to a claim against a former data processing provider. In 2000 the bank filed a breach of contract lawsuit to recover $0.5 million that was charged to its check clearing account in error. In 2000, $0.3 million of the original claim was written off and the remaining amount was written off in 2002. On February 14, 2003 a Waukesha County, Wisconsin jury delivered a verdict that the data processor did not breach its contract with the Bank. The after tax charge to income in 2002 was $0.2 million. As more fully discussed under Item 3, Part I of this report, Fiserv, Inc. has appealed the denial of the reimbursement claim for $0.4 million in legal fees. The Company has not accrued this contingent liability.

During 2002 the Bank closed its Beloit Wal Mart in-store branch. The 2002 results include an after tax charge of $40.0 thousand due to the abandonment of leasehold improvements.

In 2002 the Bank changed its vacation policy to eliminate the vesting of vacation on December 31 for the following year. Instead, vacation will be earned and used in the same calendar year. This change resulted in a $0.1 million decrease in salary and benefits expense. The Bank's future profitability is also dependent on the rapidly rising costs of health care and the cost of its group term health insurance which is anticipated to increase 10% in 2004.

Pursuant to SFAS No. 142, an accounting standard effective January 1, 2002, amortization of goodwill, which resulted from purchase accounting adjustments from previous acquisitions, was discontinued. Goodwill amortization for 2001 was $0.2 million or $0.08 per share. No transition or impairment charge was required for 2003 or 2002.

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 rate/volume analysis is prepared with non-accruing loans treated on a cash basis in accordance with the Company's practices as described in Note 5 to the Consolidated Financial Statements attached to this report. Tax equivalency is calculated based on an effective combined income tax rate of 34%.

Average Balance			Average Rate			
2003	2002	2001	2003	2002	2001	(Dollars in thousands)
						Interest Earning Assets:
$ 95,976	$ 71,938	$ 51,536	3.71%	4.86%	5.96%	Taxable investment securities
28,971	20,088	17,992	5.96%	6.43%	6.42%	Tax-exempt investment securities (1)