BLACKHAWK BANCORP INC
Form 10QSB
May 14, 2003

FORM 10-QSB
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2003

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

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

COMMISSION FILE NUMBER 0-18599

BLACKHAWK BANCORP, INC.
(EXACT NAME OF REGISTRANT 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
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)
NOT APPLICABLE

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

YES X NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

CLASS OF COMMON STOCK	OUTSTANDING AT MAY 12, 2003
$.01 PAR VALUE	2,517,131 SHARES

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PART I - FINANCIAL INFORMATION

Page

BLACKHAWK BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS

	MARCH 31, 2003
ASSETS	(Dollars in
Cash and due from banks	$ 13,134
Federal funds sold and securities purchased under agreements to resell	6,000
Interest-bearing deposits in banks	1,227
Available-for-sale securities	108,896

Held to maturity securities, at amortized cost	20,712
Loans, less allowance for loan losses of $2,197 and $2,079 at March 31, 2003 and December 31, 2002, respectively	177,478
Office buildings and equipment, net	6,612
Intangible assets	4,489
Other assets	16,213
Total Assets	$354,761

LIABILITIES AND STOCKHOLDERS' EQUITY

LIABILITIES:	
Deposits:	
Noninterest-bearing	$ 35,710
Interest-bearing	215,679
Total deposits	251,389
Short-term borrowings	22,997
Long-term borrowings	43,900
Company Obligated Mandatorily Redeemable Preferred Securities of subsidiary trust holding solely subordinated debentures	7,000
Other liabilities	3,729
Total Liabilities	329,015
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: 2,517,131 at March 31, 2003, 2,507,065 at December 31, 2002	25
Surplus	8,763
Retained earnings	15,959
Accumulated other comprehensive income	999
Total Stockholders' Equity	25,746
Total Liabilities and Stockholders' Equity	$354,761

See Notes to Unaudited Consolidated Financial Statements

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

	THREE MONTHS ENDED MARCH	
	2003	200
INTEREST INCOME:	(Dollars in thousands, except per share data	
Interest and fees on loans	$3,249	$3,
Interest and dividends on securities:		
Taxable	927	

Nontaxable	253	
Interest on fed funds sold and securities purchased under agreements to resell	41	
Interest on interest-bearing deposits in banks	10	
Total Interest Income	4,480	4,
INTEREST EXPENSE:		
Interest on deposits	1,266	1,
Interest on short-term borrowings	34	
Interest on long-term borrowings	505	
Interest on Company Obligated Mandatorily Redeemable Preferred Securities	82	
Total Interest Expense	1,887	2,
Net Interest Income	2,593	2,
Provision for loan losses	222	
Net Interest Income After Provision For Loan Losses	2,371	2,
NONINTEREST INCOME:		
Service charges on deposit accounts	337	
Gain on sale of loans	158	
Securities gains, net	329	
Other	213	
Total Noninterest Income	1,037	
NONINTEREST EXPENSES:		
Salaries and employee benefits	1,458	1,
Occupancy	189	
Equipment	230	
Data processing services	196	
Advertising and marketing	63	
Amortization of intangibles	79	
Professional fees	185	
Office supplies	63	
Telephone	75	
Other	412	
Total Noninterest Expenses	2,950	2,
Income Before Income Taxes	458	
Income Taxes	60	
Net Income	$ 398	$
Basic Earnings Per Share	$ 0.16	$ 0
Diluted Earnings Per Share	$ 0.16	$ 0
Dividends Per Share	$ 0.09	$ 0

See Notes to Unaudited Consolidated Financial Statements

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

	THREE MONTHS ENDED MARCH 31, 2003	THREE MONTHS ENDED MARCH 31, 2002
	(Dollars in thousands)	
Common Stock:		
Balance at beginning of period	$ 25	$ 24
Stock options exercised	--	--
Balance at end of period	25	24
Surplus:		
Balance at beginning of period	8,698	7,555
Stock options exercised	65	485
Sale of treasury stock	--	(2)
Balance at end of period	8,763	8,038
Retained Earnings:		
Balance at beginning of period	15,788	15,447
Net income	398	317
Dividends declared on common stock	(227)	(219)
Balance at end of period	15,959	15,545
Treasury Stock, at cost:		
Balance at beginning of period	--	(58)
Sale of treasury stock	--	16
Balance at end of period	--	(42)
Accumulated other comprehensive income:		
Balance at beginning of period	1,287	773
Other comprehensive loss, net of taxes	(288)	(330)
Balance at end of period	999	443
Total Stockholders' Equity	$25,746	$24,008

See Notes to Unaudited Consolidated Financial Statements

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

	THREE MONT MARCH 2003
	(Dollars in
CASH FLOWS FROM OPERATING ACTIVITIES:	

Net income	$ 398
Adjustments to reconcile net income to net cash provided by (used in) operating activities:	
Depreciation and amortization	328
Provision for loan losses	222
Gain on sale of loans	(158)
FHLB stock dividends	(53)
Amortization of premiums on securities, net	152
Securities gains, net	(329)
Decrease in accrued interest receivable	116
Decrease in accrued interest payable	(3)
Increase in other assets	(2,701)
Increase (decrease) in other liabilities	(221)
Net cash provided by (used in) operations before loan originations and sales	(2,249)
Origination of loans for sale	(6,883)
Proceeds from sale of loans	8,989
Net cash provided by (used in) operating activities	(143)
CASH FLOWS FROM INVESTING ACTIVITIES:	
Net (increase) decrease in interest-bearing deposits in banks	7,245
Net decrease in federal funds sold and securities purchased under agreements to resell	7,120
Proceeds from sales of available-for-sale securities	10,884
Proceeds from maturities and calls of available-for-sale securities	9,032
Proceeds from maturities and calls of held-to-maturity securities	2,274
Purchase of available-for-sale securities	(45,155)
Purchase of held-to-maturity securities	--
Net decrease in loans	6,587
Proceeds from the sale of office buildings, equipment, and other real estate owned	131
Purchase of office buildings and equipment, net	(83)
Net cash provided by (used in) investing activities	(1,965)

See Notes to Unaudited Consolidated Financial Statements.

BLACKHAWK BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(CONTINUED)

	THREE MONTH MARCH 2003
	(Dollars in t
CASH FLOWS FROM FINANCING ACTIVITIES:	
Net decrease in deposits	$(11,696)
Dividends paid	(226)
Proceeds from other borrowings	5,000
Payments on other borrowings	--
Net increase in short-term borrowings	9,543
Proceeds from exercise of stock options	49
Sale of treasury stock	--

Net cash provided by (used in) financing activities	2,670
Net increase (decrease) in cash and due from banks	562
CASH AND DUE FROM BANKS:	
Beginning	12,572
Ending	$ 13,134
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:	
Cash paid during the year for:	
Interest	$ 1,890
Income taxes	$ --
SUPPLEMENTAL SCHEDULES OF NON-CASH INVESTING ACTIVITIES:	
Change in accumulated other comprehensive income unrealized gains (losses) on available-for-sale securities, net	$ (288)
Other assets acquired in settlement of loans	$ 64

See Notes to Unaudited Consolidated Financial Statements.

BLACKHAWK BANCORP, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2003

Note 1. General:

The unaudited consolidated financial statements include the accounts of Blackhawk Bancorp, Inc. and its subsidiaries. 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 months ended March 31, 2003 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 Corporation'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, 2002 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 2002 historical financial statements to conform to the 2003 presentation.

Stock-Based Compensation Plan: At March 31, 2003, the Company had a stock-based director, key officer and employee compensation plan. The Company accounts for this plan 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.

(Dollars in thousands, except per share data)	Three Months Ended March 31, 2003	2002
Net income, as reported	$ 398	$ 317
Deduct total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(21)	(18)
PRO FORMA NET INCOME	$ 377	$ 299
Earnings per share:		
Basic:		
As reported	$ 0.16	$ 0.13
Pro forma	0.15	0.13
Diluted:		
As reported	0.16	0.13
Pro forma	0.15	0.12

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: dividend yield of 4 percent; expected price volatility of 25 percent; risk-free interest rates of 4 percent; and expected lives of 10 years.

Note 2. Allowance for Loan Losses

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

	THREE MONTHS ENDED MARCH 31, (Dollars in thousands) 2003	2002

Balance at beginning of period	$2,079	$2,404
Provision charged to expense	222	139
Loans charged off	157	51
Recoveries	53	25
Balance at end of period	$2,197	$2,517

Note 3. Earnings Per Share

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

	THREE MONTHS ENDED MARCH 31, 2003	2002
Basic:		
Net income available to common stockholders	$ 398,000	$ 317,000
Weighted average shares outstanding	2,514,018	2,384,341
Basic earnings per share	$ 0.16	$ 0.13
Diluted:		
Net income available to common stockholders	$ 398,000	$ 317,000
Weighted average shares outstanding	2,514,018	2,384,341
Effect of dilutive stock options outstanding	4,721	9,796
Diluted weighted average shares outstanding	2,518,739	2,394,137
Diluted earnings per share	$ 0.16	$ 0.13

Note 4. Recent Accounting Developments

The Financial Accounting Standards Board has issued Statement 149, "Amendment of Statement 133 on Derivative Instruments and Hedging". This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under Statement 133. The Statement is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. Implementation of the Statement is not expected to have a material impact on the company's financial statements.

Note 5. Recent Regulatory Developments

On July 30, President Bush signed the Sarbanes-Oxley Act of 2002 (the "Act"). This legislation 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. Other provisions will become effective as the SEC adopts appropriate rules.

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 OF FINANCIAL CONDITION AND RESULTS 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, 2002.

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 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.

RESULTS OF OPERATIONS

The company reported net income of $398,000 for the three months ended March 31, 2003, an increase of $81,000 or 25.5% from the $317,000 reported for the same three month period in 2002. Diluted earnings per share were $0.16 for the three months ended March 31, 2003 compared to $0.13 for the same period in 2002 and represents an increase of 23.1% year over year.

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 shareholders' equity, interest income and expense on related items, and the company's average rate for the three month periods ended March 31, 2003 and 2002. 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 March 31, 2003			Three
	Average Balance	Interest	Average Rate	Averag Balanc
INTEREST EARNING ASSETS:				
Interest-bearing deposits in banks	$ 2,144	$ 10	1.89%	$ 6,28
Federal funds sold & securities purchased under agreements to resell	8,543	41	1.95%	8,44
Investment securities:				
Taxable investment securities	84,642	927	4.44%	50,38
Tax-exempt investment securities	24,978	383	6.22%	19,30
Total investment securities	109,620	1,310	4.85%	69,68
Loans	182,957	3,249	7.20%	203,84
TOTAL EARNING ASSETS	$303,264	$4,610	6.16%	$288,25
Allowance for loan losses	(2,146)			(2,519
Cash and due from banks	10,453			9,45
Other assets	21,606			17,47
TOTAL ASSETS	$333,177			$312,66
INTEREST BEARING LIABILITIES:				
Interest bearing checking accounts	$ 37,974	$ 87	.93%	$ 31,11
Savings deposits	52,577	110	.85%	53,82
Time deposits	122,800	1,069	3.53%	121,03
Total interest bearing deposits	213,351	1,266	2.41%	205,97
Short-term borrowings	12,448	34	1.11%	9,78
Long-term borrowings	40,844	505	5.01%	42,38

Trust Preferred Securities	7,000	82	4.75%	-0
TOTAL INTEREST-BEARING LIABILITIES	$273,643	$1,887	2.80%	$258,14
NET INTEREST SPREAD			3.37%	
Noninterest bearing deposits	31,789			28,23
Other liabilities	1,878			2,25
Total liabilities	307,310			288,63
Stockholders' equity	25,867			24,02
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$333,177			$312,66
NET INTEREST MARGIN		$2,723	3.64%	

Net interest income decreased by $74,000, or 2.6%, to $2,723,000 for the quarter ended March 31, 2003, compared to $2,797,000 for the comparable period in 2002. The net interest margin, which is the tax equivalent net interest income divided by average interest earning assets was 3.64% for the three months ended March 31, 2003 compared to 3.94% for the same period in 2002. The 30 basis point decrease in net interest margin is primarily due to shifts in the Company's earning asset mix and the impact of the sustained low interest rate environment.

For the three months ended March 31, 2003, total interest income decreased by $358,000, or 7.2%, to $4,610,000 compared to $4,968,000 for the same period in 2002. The yield on average earning assets decreased 83 basis points to 6.16% for the first quarter of 2003, compared to 6.99% for the same period in 2002. The decreases in interest income and the yield on earning assets is the result the shift in the Bank's earning assets from loans to investment securities and the sustained lower market interest rates, which are at 40-year lows. Average loans decreased $20,883,000 or 10.2% to $182,957,000 for the quarter ended March 31, 2003 compared to $203,840,000 for the same period in 2002. Average investment securities increased $39,933,000 or 57.3% to $109,620,000 for the three months ended March 31, 2003 compared to $69,687,000 for the first quarter of 2002. The decrease in interest income due to shifts in the asset mix and the low interest rate environment were partially offset by a $15,006,000 or 5.2% increase in average earning assets.

Interest and fees on loans decreased 16.9% to $3,249,000 for the three months ended March 31, 2003 compared to $3,909,000 for the same period of 2002. This decrease was the result of a $20,833,000 or 10.2% decrease in average loans outstanding and a 58 basis point decrease in yield on the portfolio. Of the $20,833,000 decrease in average total loans, $14,886,000 was in the 1-4 family residential real estate loans and $5,249,000 was in the direct and indirect consumer loan categories. These decreases reflect the refinancing activity due to interest rates reaching 40- year lows, as consumers re-finance their existing mortgages and use equity in their homes to consolidate other debt into secondary market loan products. The lower yield on average loans reflects the overall lower interest rate environment and competitive pricing pressure for quality credit customers.

Interest income on taxable securities increased by $236,000 or 34.2% in the first quarter of 2003 to $927,000 compared to $691,000 for the same period in 2002. Average balances of taxable investment securities increased 68.0% to $84,642,000 for the quarter ended March 31, 2003 compared to $50,381,000 for the same period in the prior year. However, the yield on average taxable investment securities decreased 112 basis points to 4.44% for the first quarter of 2003 compared to 5.56% for the first quarter of 2002. Tax exempt investment securities increased $5,672,000, or 29.4% to an average balance of $24,978,000 for the three months ended March 31, 2003 compared to $19,306,000 for the same period in 2002, while the yield decreased 25 basis points to 6.22%.

Interest from fed funds sold and securities purchased under agreements to resell increased to $41,000 for the three month period ended March 31, 2003, compared to $33,000 during the same periods in 2002. The increase reflects an increased use of securities purchased under agreements to resell as a short-term investment vehicle, which achieves a higher yield than fed funds, in 2003 compared to 2002.

Total interest expense decreased by $284,000, or 13.1%, to $1,887,000 for the three months ended March 31, 2003 compared to $2,171,000 for the same period in 2002. The decrease in total interest expense is primarily the result of the aforementioned lower market interest rate environment. The decrease from the lower rate environment was partially offset by a $15,499,000 or 6.0% increase in total interest-bearing liabilities.

Interest paid on deposits decreased $295,000, or 18.9% to $1,266,000 during the three months ended March 31, 2003 compared to $1,561,000 for the same period in 2002. The decrease in interest paid on deposits, which was due to the overall lower interest rate environment, was partially offset by a $7,376,000 or 3.6% increase in total interest-bearing deposits. The majority of the interest-bearing deposit growth was in interest-bearing checking accounts, which increased $6,858,000 or 22.0% for the first quarter of 2003 to $37,974,000 compared to $31,116,000 for the same period in 2002. The average balance of noninterest-bearing demand deposits increased by 12.6% or $3,554,000 to $31,789,000 for the three months ended March 31, 2003 compared to $28,235,000 for the first quarter of 2002.

Interest on short-term borrowings decreased $12,000 to $34,000 for the three months ended March 31, 2003 compared to $46,000 for the same period in 2002. This decrease is the result of lower market rates paid on short-term borrowings. The decrease due to lower rates was partially offset by a $2,667,000 or 27.3% increase in the average balance of short-term borrowings.

Interest expense on long-term borrowings decreased $59,000 to $505,000 for the three month period ended March 31, 2003 compared to $564,000 for the first three months of 2002. The decrease is the result of a 39 basis point decrease in the average rate to 5.01% for the first quarter of 2003 compared to 5.40% for the first quarter of 2002 and a $1,544,000 or 3.6% decrease in the average balance comparing the same two periods. The decrease in the average balance of long-term borrowings is due to a reduced usage of bank debt as a result of the issuance of $7,000,000 in trust preferred securities in December 2002. The decrease in the usage of bank debt was partially offset by increases in Federal Home Loan Bank Advances.

Interest expense of trust preferred securities was $82,000 for the first quarter of 2003 compared to none in the first quarter of 2002. In December of 2002 the Company issued $7,000,000 of trust preferred securities through a special purpose statutory trust. The proceeds from these securities were used to reduce reliance on bank debt.

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 (reduce) 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 $222,000 in the first quarter of 2003, an increase of $83,000 or 59.7% from the $139,000 in the first quarter of 2002.

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 first quarter of 2003 increased by $78,000 or 300.0% to $104,000 compared to $26,000 for the first quarter of 2002.

The increases in the provision and a decrease in the loan portfolio, partially offset by higher net charge-offs have resulted in an increase in the ratio of the allowance to total loans to 1.22% at March 31, 2003 compared to 1.10% at December 31, 2002.

NONINTEREST INCOME

Total noninterest income increased $395,000, or 61.5%, to $1,037,000 for the three months ended March 31, 2003 compared to $642,000 for the same period in 2002 primarily as the result of increases in security gains recognized and an increase in gains on the sale of mortgage loans sold to the secondary market.

Service charges on deposit accounts were $337,000 for the quarter ended March 31, 2003 compared to $349,000 for the first quarter of 2002. The decrease reflects a lower volume of overdraft fees assessed.

Gain on the sale of mortgage loans increased $85,000 or 116.4% to $158,000 for the first quarter of 2003 compared to the $73,000 of gains recognized during the first quarter of 2002. In the first quarter of 2003, $8,989,000 of mortgage loans were sold to the secondary market compared to $8,309,000 for the same period in 2002. The average gain in 2003 was 1.76% compared to an average gain of .88% on the loans sold in the first quarter of 2002. The higher margins realized on the sale of loans is due to a change in investors buying the loans, more consistent pricing practices and closer management of the delivery commitments.

The Company recognized $329,000 of securities gains in the first quarter of 2003 compared to $4,000 in the first quarter of 2002. Due to available liquidity from increased deposits and reductions in the loan portfolio, $10,884,000 of investment securities that would have matured or been called in the next 12 to 18 months were sold and the proceeds invested in longer term securities.

Other noninterest income decreased $3,000 or 1.4% for the three months ended March 31, 2003. Increase in cash surrender value of life insurance increased by $68,000 quarter over quarter, but was offset by decreases in foreign ATM fees from the closure of the Wal-Mart branch in October 2002, higher mortgage servicing rights amortization and a decrease in the volume of credit life and A&H insurance sold.

NONINTEREST EXPENSES

Total noninterest expense increased $169,000, or 6.1%, to $2,950,000 for the three months ended March 31, 2003 compared to $2,781,000 for the same period in 2002. The increase includes a $65,000 or 5% increase in salary and employee benefits to $1,458,000 for the first quarter of 2003 compared to $1,393,000 for the first quarter of 2002. This increase is partially due to the expansion of health benefits to certain part-time employees.

Other expenses increased $86,000 or 26.4% to $412,000 for the three months ended March 31, 2003 compared to $326,000 for the same period a year ago. This increase includes $56,000 related to a sales and use tax audit covering the period from 1998 through 2002 and higher costs related to the Company's courier service and loan collection costs.

Income taxes decreased $36,000, or 37.5%, to $60,000 for the three months ended March 31, 2003 from $96,000 for the same period in 2002. The decline in effective tax rate to 13.1% for the three month period ended March 31, 2003 from 23.2% for the same period of 2002 is reflective of greater tax efficiency brought about by an increase in non-taxable interest from the municipal bond portfolio, an increase in non-taxable life insurance cash surrender value build-up and security gains recognized by the Bank's investment subsidiary that are not taxable for state income tax purposes.

BALANCE SHEET ANALYSIS

OVERVIEW

Total assets increased to $354,761,000 at March 31, 2003 compared to $352,377,000 at December 31, 2002, an increase of .7%. The December 31, 2002 balance sheet included short-term year-end deposits of $18,600,000, which were invested in federal funds sold and interest bearing deposits in banks at December 31, 2002. Excluding these deposits, total assets increased 6.3% from December 31, 2002 to March 31, 2003. While total assets excluding the short-term year-end deposits increased by $20,984,000, there was a considerable shift in balances from loans to investment securities. Securities available for sale increased by $24,999,000, while loans, net of allowance for loan losses, decreased by $8,822,000.

LOANS

Net loans decreased $8,822,000, or 4.7%, to $177,478,000 on March 31, 2003 compared to $186,300,000 on December 31, 2002. The composition of loans is shown in the following table:

	March 31, 2003	December 31, 2002	Change in Balance	As a % of Total Loans March 31, 2003	As a % of Total Loans December 31, 2002
	(Dollars in millions)				
Residential Real Estate	$68.1	$71.8	($3.7)	37.9%	38.1%
Commercial Real Estate	$33.8	$32.7	$1.1	18.8%	17.4%
Construction and Land Development	$6.3	$6.4	($0.1)	3.5%	3.4%
Commercial	$50.0	$54.6	($4.6)	27.8%	29.0%
Consumer	$20.9	$22.3	($1.4)	11.6%	11.8%
Other	$0.6	$0.6	$0.0	0.4%	0.3%

The historically low interest rate environment has led to substantial prepayments on the company's 1-4 family residential real estate portfolio. Also, the economic conditions in the company's primary markets have adversely affected loan demand leading to decreases in all categories of loans outstanding, except for commercial real estate. In addition, the company's focus on relationship banking has resulted in the subsidiary bank not pursuing certain "transactions" that may have resulted in increased loan balances, but offered no opportunity to form other relationships with the client.

NON-PERFORMING LOANS

Non-performing loans includes loans which have been categorized by management as non-accruing because collection of interest is not assured, and 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)	MARCH 31, 2003	DECEMBER 31, 2002
Non-accruing loans	$ 3,028	$2,560
Past due 90 days or more and still accruing	10	26
Total non-performing loans	$3,038	$2,586
Restructured loans performing in accordance with modified terms	$ 400	$ 418

ASSET QUALITY

The allowance for loan losses was $2,197,000 or 1.22% of total loans at March 31, 2003 compared to $2,079,000 or 1.10% of total loans at December 31, 2002. As of March 31, 2003, non-performing loans and restructured loans performing in accordance with modified terms (restructured loans) totaled $3,438,000 compared to $3,004,000 at December 31, 2002. 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 dept or in its restoration to current status.

At March 31, 2003 the allowance for loan losses to total non-performing and restructured loans equaled 63.9% compared to 69.2% at December 31, 2002. Total nonperforming and restructured loans increased by $434,000 primarily due to increases in non-accrual single family first mortgage loans and consumer loans. Non-accrual first mortgage loans and consumer loans were $1,932,000 and $358,000 at March 31, 2003 compared to $1,661,000 and $206,000 at December 31, 2002, respectively.

SHORT-TERM INVESTMENTS

Fed funds sold and securities purchased under agreements to resell decreased $7,120,000 to $6,000,000 at March 31, 2003 compared to $13,120,000 at December 31, 2002. The decrease reflects the liquidation of short-term year-end investments on January 2, 2003 associated with the December 31, 2002 year-end deposits of $18,600,000 referred to above.

Interest-bearing deposits in banks decreased $7,245,000 to $1,227,000 at March 31, 2003 compared to $8,472,000 at December 31, 2002. The decrease reflects the liquidation of $7,000,000 in short-term year-end investments at the Federal home Loan Bank of Chicago on January 2, 2003 associated with the December 31, 2002 year-end deposits of $18,600,000 referred to above.

INVESTMENT SECURITIES

Securities available for sale increased $24,999,000, or 29.8%, to $108,896,000 at March 31, 2003 compared to $83,897,000 at December 31, 2002. The increase in investments in securities available for sale resulted from the redeployment of cash flows from the decrease in loans, investment of funds from increased deposits, net of the year end short-term deposits, and the purchase of $5,400,000 in securities during the first quarter of 2003 that were funded with Federal Home Loan Bank advances. Securities held to maturity decreased $2,290,000 or 10.0% to $20,712,000 at March 31, 2003 from $23,002,000 at December 31, 2002 as a result of securities maturing.

DEPOSITS

Total deposits decreased $11,696,000 to $251,389,000 at March 31, 2003 compared to $263,085,000 at December 31, 2002. As noted above, the Company's December 31, 2002 financial statements reflect short-term year-end deposits of $18,600,000. Excluding the short-term year-end deposits, total deposits increased 2.8% from December 31, 2002. Excluding the short-term year-end deposits, non-interest bearing deposits increased by $436,000 and interest bearing deposits increased by $6,468,000 at March 31, 2003 compared to December 31, 2002.

BORROWINGS

Short-term borrowings increased $9,543,000 to $22,997,000 at March 31, 2003 from $13,454,000 at year-end. The increase is due to purchasing $14,901,000 of fed funds at March 31, 2003 offset by lower outstanding balances of repurchase agreements with commercial customers, which decreased by $5,358,000 since December 31, 2002. Long-term borrowings consist of term advances from the Federal Home Loan Bank ("FHLB") and were $43,900,000 at March 31, 2003 compared to $38,900,000 at December 31, 2002. The increase reflects an additional $5,000,000 in FHLB advances invested into investment securities in the first quarter of 2003.

SHAREHOLDERS' EQUITY

Total shareholders' equity decreased $52,000 to $25,746,000 at March 31, 2003 compared to $25,798,000 at December 31, 2002. During the first three months of 2003 surplus increased by $65,000 from the sale of stock for options exercised. Accumulated other comprehensive income which is the adjustment of securities available for sale to market value, net of tax, decreased $288,000 to $999,000 at March 31, 2003 from $1,287,000 at December 31, 2002. The decrease reflects a reduction for the securities gains of $329,000 realized in the first quarter of 2003. In addition the company declared a dividend of $0.09 per share on common stock, which totaled $227,000.

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.

	MARCH 31, 2003	DECEMBER 31, 2002	REGULATORY REQUIREMENTS
Total Capital (To Risk-Weighted Assets)	14.4%	13.9%	8.0%
Tier I Capital (To Risk-Weighted Assets)	13.3%	12.9%	4.0%
Tier I Capital (To Average Assets)	8.4%	8.3%	4.0%

The Company's subsidiary bank 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 rather than on the amount of assets and/or liabilities subject to repricing in a given time period. 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 the 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.

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, maturities 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 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 March 31, 2003 (in thousands):

Time Deposits	Long-term debt(1)	Operating