

**BLACKHAWK BANCORP, INC.
AND SUBSIDIARY**

Consolidated Financial Statements

Years Ended December 31, 2014 and 2013

Blackhawk Bancorp, Inc. and Subsidiary

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Independent Auditor's Report

To the Board of Directors
Blackhawk Bancorp, Inc. and Subsidiary
Beloit, Wisconsin

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Blackhawk Bancorp, Inc. and Subsidiary (the "Company"), which comprise the consolidated balance sheets as of December 31, 2014 and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

To the Board of Directors
Blackhawk Bancorp, Inc. and Subsidiary

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Blackhawk Bancorp, Inc. and Subsidiary as of December 31, 2014 and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Prior Year Consolidated Financial Statements

The consolidated financial statements of Blackhawk Bancorp, Inc. and Subsidiary as of December 31, 2013 were audited by other auditors, whose report dated March 20, 2014 expressed an unqualified opinion on those consolidated financial statements.

Plante & Moran, PLLC

Chicago, Illinois
March 6, 2015

Blackhawk Bancorp, Inc. and Subsidiary

Consolidated Balance Sheets December 31, 2014 and 2013

Assets	2014	2013
	<i>(Amounts in thousands, except share and per share data)</i>	
Cash and due from banks	\$ 9,847	\$ 11,350
Securities purchased under agreements to resell	-	21,064
Interest-bearing deposits in banks and other	11,744	2,078
Total cash and cash equivalents	21,591	34,492
Securities available-for-sale	129,184	127,985
Loans held for sale	1,537	1,161
Federal Home Loan Bank stock, at cost	2,266	2,266
Loans, less allowance for loan losses of \$4,396 and \$4,894 at December 31, 2014 and 2013, respectively	391,448	382,295
Premises and equipment, net	8,320	8,922
Goodwill	5,037	5,037
Mortgage servicing rights	2,640	3,066
Cash surrender value of bank-owned life insurance	9,602	9,311
Other assets	9,848	8,905
Total assets	<u>\$ 581,473</u>	<u>\$ 583,440</u>
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$ 99,068	\$ 91,450
Interest-bearing	416,716	419,308
Total deposits	515,784	510,758
Subordinated debentures and notes (including \$1,031 at fair value at December 31, 2014 and 2013)	11,255	11,255
Senior secured term note	9,000	-
FHLB advances (including \$2,157 at fair value at December 31, 2013)	-	10,157
Other liabilities	3,398	2,968
Total liabilities	<u>539,437</u>	<u>535,138</u>
Stockholders' Equity		
Preferred stock, \$0.01 par value, 1,000,000 shares authorized; 0 and 10,500 shares issued as of December 31, 2014 and 2013, respectively	-	10,483
Common stock, \$0.01 par value, 10,000,000 shares authorized; 2,318,496 and 2,299,496 shares issued as of December 31, 2014 and 2013, respectively	23	23
Additional paid-in capital	9,960	9,768
Retained earnings	31,091	29,166
Treasury stock, 87,865 and 83,252 shares, at cost as of December 31, 2014 and 2013, respectively	(969)	(909)
Accumulated other comprehensive income (loss)	1,931	(229)
Total stockholders' equity	<u>42,036</u>	<u>48,302</u>
Total liabilities and stockholders' equity	<u>\$ 581,473</u>	<u>\$ 583,440</u>

See Notes to Consolidated Financial Statements.

Blackhawk Bancorp, Inc. and Subsidiary
Consolidated Statements of Income
Years Ended December 31, 2014 and 2013

	2014	2013
	<i>(Amounts in thousands, except per share data)</i>	
Interest Income:		
Interest and fees on loans	\$ 18,711	\$ 19,060
Interest and dividends on available-for-sale securities:		
Taxable	2,106	1,953
Tax-exempt	1,314	1,257
Interest on securities purchase under agreements to resell	156	364
Interest on other	18	59
Total interest income	22,305	22,693
Interest Expense:		
Interest on deposits	2,067	2,591
Interest on subordinated debentures and notes	609	513
Interest on senior secured term note	249	51
Interest on FHLB advances	34	155
Total interest expense	2,959	3,310
Net interest income before provision for loan losses	19,346	19,383
Provision for loan losses	2,285	4,140
Net interest income after provision for loan losses	17,061	15,243
Noninterest Income:		
Service charges on deposit accounts	2,832	2,820
Net gain on sale of loans	1,824	2,948
Net loan servicing income	236	13
Debit card interchange fees	2,223	2,230
Other-than-temporary loss:		
Total impairment loss	(170)	(232)
Loss recognized in other comprehensive income	-	86
Net impairment loss recognized in earnings	(170)	(146)
Net gains on sales of securities available-for-sale	640	2,732
Loss on repurchase agreement	(2,611)	-
Increase in cash surrender value of bank-owned life insurance	291	295
Other	691	382
Total noninterest income	5,956	11,274
Noninterest Expenses:		
Salaries and employee benefits	11,295	11,412
Occupancy and equipment	2,522	2,623
Data processing	2,344	2,346
FDIC assessment	448	767
Advertising and marketing	249	262
Professional fees	875	1,161
Office supplies	373	371
Telephone	386	367
Other	2,258	2,386
Total noninterest expenses	20,750	21,695
Income before income taxes	2,267	4,822
Provision for income taxes	15	907
Net income	\$ 2,252	\$ 3,915
Basic Earnings per Share	\$ 0.92	\$ 1.48
Diluted Earnings per Share	0.92	1.47

See Notes to Consolidated Financial Statements.

Blackhawk Bancorp, Inc. and Subsidiary
Consolidated Statements of Comprehensive Income
Years Ended December 31, 2014 and 2013

	2014	2013
	<i>(Amounts in thousands, except per share data)</i>	
Net income	\$ 2,252	\$ 3,915
Other comprehensive income (loss):		
Unrealized gains/(losses) on securities:		
Unrealized holding gains (losses) arising during the period	4,141	(2,720)
Reclassification adjustment for gains included in net income	(640)	(2,732)
	3,501	(5,452)
Tax effect	(1,341)	2,101
Net of tax	2,160	(3,351)
Unrealized gains/(losses) on securities for which a portion of an other-than temporary impairment has been recognized:		
Unrealized holding gains arising during the period	-	509
Tax effect	-	(199)
Net of tax	-	310
Total other comprehensive income (loss)	2,160	(3,041)
Total comprehensive income	\$ 4,412	\$ 874

See Notes to Consolidated Financial Statements.

Blackhawk Bancorp, Inc. and Subsidiary
Consolidated Statements of Changes in Stockholders' Equity
Years Ended December 31, 2014 and 2013

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2012	\$ 10,383	\$ 23	\$ 9,619	\$ 25,896	\$ (909)	\$ 2,812	\$ 47,824
Net income				3,915			3,915
Other comprehensive loss						(3,041)	(3,041)
Accretion of preferred stock warrants	100			(100)			-
Cash dividends paid on preferred stock				(545)			(545)
Vesting of shares of restricted stock			83				83
Vesting of shares of restricted stock units			66				66
Balance, December 31, 2013	10,483	23	9,768	29,166	(909)	(229)	48,302
Net income				2,252			2,252
Other comprehensive income						2,160	2,160
Accretion of preferred stock warrants	17			(17)			-
Cash dividends paid on preferred stock				(177)			(177)
Redemption of preferred stock	(10,500)						(10,500)
Cash dividends paid on common stock				(133)			(133)
Purchase of treasury shares					(60)		(60)
Vesting of shares of restricted stock			126				126
Vesting of shares of restricted stock units			66				66
Balance, December 31, 2014	\$ -	\$ 23	\$ 9,960	\$ 31,091	\$ (969)	\$ 1,931	\$ 42,036

See Notes to Consolidated Financial Statements.

Blackhawk Bancorp, Inc. and Subsidiary

Consolidated Statements of Cash Flows
Years Ended December 31, 2014 and 2013

	2014	2013
	<i>(Amounts in thousands)</i>	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 2,252	\$ 3,915
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	916	937
Amortization of intangibles	25	139
Stock-based compensation expense, net of tax benefits	192	149
Provision for loan losses	2,285	4,140
Increase in cash surrender value of bank-owned life insurance, net	(291)	(295)
Origination of loans held-for-sale	(66,465)	(127,442)
Proceeds from sales of loans held-for-sale	67,923	130,821
Net gain on sale of loans	(1,824)	(2,948)
Deferred income tax (benefit) expense	(1,549)	1,069
Loss on repurchase agreement	2,611	-
Net other losses	247	630
Net accretion on securities available-for-sale	(1,957)	(1,779)
Loss on investment in affordable housing partnership	119	148
Securities impairment loss recognized in earnings	170	146
Net gains on sales of securities available-for-sale	(640)	(2,732)
Net change in:		
Mortgage servicing rights	426	7
Other assets	(4,408)	1,873
Other liabilities	430	(55)
Net cash provided by operating activities	462	8,723
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sales of securities available-for-sale	45,041	19,014
Proceeds from maturities and calls of securities available-for-sale	20,071	24,908
Purchases of securities available-for-sale	(60,383)	(51,408)
Loan origination and payments, net	(12,556)	(28,706)
Proceeds from the sales of premises and equipment	228	60
Proceeds from the sales of foreclosed assets	1,720	2,104
Purchase of office premises and equipment	(483)	(1,476)
Net cash used in investing activities	(6,362)	(35,504)

(Continued)

Blackhawk Bancorp, Inc. and Subsidiary**Consolidated Statements of Cash Flows (continued)**
Years Ended December 31, 2014 and 2013

	2014	2013
	<i>(Amounts in thousands)</i>	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	\$ 5,026	\$ 16,937
Net change in short term FHLB advances	(8,000)	6,000
Payments on FHLB advances	(2,157)	-
Proceeds from senior secured term note	9,000	-
Payments on senior secured term note	-	(5,779)
Cash dividends paid on preferred stock	(177)	(545)
Cash dividends paid on common stock	(133)	-
Purchase of treasury shares	(60)	-
Redemption of preferred stock	(10,500)	-
Proceeds from issuance of subordinated notes	-	6,100
Net cash used in (provided by) in financing activities	<u>(7,001)</u>	<u>22,713</u>
 Net decrease in cash and cash equivalents	 (12,901)	 (4,068)
 CASH AND CASH EQUIVALENTS:		
Beginning	<u>34,492</u>	<u>38,560</u>
 Ending	 <u>\$ 21,591</u>	 <u>\$ 34,492</u>
 SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash payments for:		
Interest	\$ 2,967	\$ 3,363
Income taxes	\$ 675	\$ 570
 SUPPLEMENTAL SCHEDULES OF NON-CASH INVESTING ACTIVITIES:		
Foreclosed assets acquired in settlement of loans	\$ 1,118	\$ 3,165

See Notes to Consolidated Financial Statements

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 1. Nature of Business and Significant Accounting Policies

Nature of Operations: The consolidated income of Blackhawk Bancorp, Inc. (the Company) is principally from the income of its wholly-owned subsidiary, Blackhawk Bank (the Bank). The Bank grants commercial, residential, and consumer loans, accepts deposits, and provides investment services to customers primarily in northern Illinois and southern Wisconsin. The Bank is subject to competition from other financial institutions and nonfinancial institutions providing financial products.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. The Bank includes the accounts of its wholly-owned subsidiary, Nevahawk Investment, Inc. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States and conform to general practices within the banking industry. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

Significant Group Concentrations of Credit Risk: Most of the Company's activities are with customers located within northern Illinois and southern Wisconsin. Notes 3 describes the types of the securities in which the Company invests, and Note 4 describes the types of lending in which the Company engages. The Company does not have any significant concentrations to any one industry or customer. The ability of the Company's debtors to honor their loan contracts is dependent upon the real estate and general economic conditions in northern Illinois and southern Wisconsin.

Use of Estimates: In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include: the determination of the allowance for loan losses, loan servicing rights, the determination of fair value of securities, determination of the value of deferred tax assets, the determination of the fair value of foreclosed assets, and the fair value of other financial instruments.

Cash and Cash Equivalents: For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold, securities purchased under agreements to resell, and interest-bearing deposits in banks which have original maturities less than ninety days.

Securities Available-For-Sale: Debt securities, including equity securities with readily determinable fair values, are classified as "available-for-sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in accumulated other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in fair value of securities available-for-sale below their amortized cost that are deemed to be an other-than-temporary impairment (OTTI) loss are reflected in earnings as realized losses. In estimating OTTI, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Securities Available-For-Sale (Continued):

The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows. Gains and losses on the sale of securities available-for-sale are recorded on the trade date and are determined using the specific identification method.

Federal Home Loan Bank Stock: The Bank, as a member of the Federal Home Loan (FHLB) system, is required to maintain minimum investments in capital stock based on the level of borrowings and other factors. The members may choose to invest in amounts greater than the required investment. FHLB stock is reported at cost, classified as a restricted security, and is periodically evaluated for impairment based on the recovery of par value. No ready market exists for FHLB stock, and it has no quoted market value.

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or estimated market value. Net unrealized losses are recognized through a valuation allowance by charges to income. All sales are made without recourse.

Loan Servicing: Mortgage servicing rights are recognized as separate assets when rights are acquired through sales of loans and servicing rights are retained. Servicing rights are initially recorded at fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses.

Capitalized mortgage servicing assets are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

Mortgage servicing rights are evaluated for impairment based upon the fair value of the rights as compared to the amortized cost. Impairment is determined by stratifying rights into tranches based upon predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent the fair value is less than the capitalized amount for the tranche. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income.

Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal and are recorded as income when earned. The amortization of mortgage servicing rights is netted against servicing fee income.

Loans: Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoff, are stated at the amount of unpaid principal plus net deferred fees and costs, reduced by an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees net of certain origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Loans (Continued):

The accrual of interest income on loans is discontinued when, in the opinion of management, there is reasonable doubt as to the borrower's ability to meet payment of interest or principal when they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Accrual of interest is generally resumed when the customer is current on all principal and interest payments and future payments are reasonably assured.

Allowance for Loan Losses: The allowance for loan losses (the allowance) 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 collectability of the principal is unlikely. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are individually considered impaired. For such loans that are considered as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than carrying value of that loan.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current environmental or economic factors. The historical loss experience is determined based on the actual loss history experienced by the Company. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; changes in underlying collateral values; and effects of changes in credit concentrations.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not considered impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, the fair value of the collateral, less estimated selling costs, if the loan is collateral dependent.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Allowance for Loan Losses (Continued):

A troubled debt restructuring of a loan is undertaken to improve the likelihood that the loan will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. All modified loans are evaluated to determine whether the loan should be reported as a troubled debt restructuring (TDR). A loan is classified as a TDR when the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower by modifying or renewing a loan under terms that the Company would not otherwise consider. To make this determination, the Company must determine whether (a) the borrower is experiencing financial difficulties and (b) the Company granted the borrower a concession. This determination requires consideration of all the facts and circumstances surrounding the modification. An overall general decline in the economy or some level of deterioration in a borrower's financial condition does not inherently mean the borrower is experiencing financial difficulties.

Some of the factors considered by management when determining whether a borrower is experiencing financial difficulties are: (1) is the borrower currently in default on any of its debts, (2) has the borrower declared or is in the process of declaring bankruptcy, and (3) absent the current modification, the borrower would likely default.

Credit Related Financial Instruments: In the ordinary course of business, the Company has entered into off-balance-sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded. Standby letters of credit are considered financial guarantees in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 460-10 and are recorded at fair value, if material.

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales, only when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of the right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Cash Surrender Value of Bank-Owned Life Insurance: The Bank has purchased life insurance policies on certain key employees to help offset the cost of increasing employee benefits. Bank-owned life insurance is recorded at its cash surrender value, or the amount that can be realized. The Bank is the beneficiary of these policies.

Premises and Equipment: Office buildings and furniture and equipment are stated at cost, less accumulated depreciation. Provisions for depreciation are computed principally on a straight-line basis, over the estimated useful lives of the assets. Office buildings and improvements are depreciated over lives of 15-40 years and furniture and equipment over 3-7 years.

Goodwill: The Company's goodwill represents the excess of cost over the fair value of net assets acquired arising from the purchase of certain assets and the assumption of certain liabilities from unrelated entities. Goodwill is not amortized, rather, it is evaluated annually for impairment. During 2014 and 2013, the Company elected to perform a qualitative assessment of its goodwill, and based on the assessment results,

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 1. Nature of Business and Significant Accounting Policies (Continued)

determined that no impairment existed as of December 31, 2014 and 2013. Any impairment, if applicable, would be recorded in earnings in the period of impairment.

Core Deposit Intangible: Core deposit intangibles are amortized over periods of 4 to 11 years, the estimated useful life of the underlying deposits. As of December 31, 2014 and 2013, the value of the core deposit intangible was \$0 and \$25, respectively, and is included in other assets in the balance sheet.

Foreclosed Assets: Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value, less estimated costs to sell, through a charge to the allowance for loan losses, if necessary. Subsequent to foreclosure, valuations are periodically performed by management and write-downs required by changes in estimated fair value are charged against earnings through a valuation allowance. Revenue and expenses from holding the assets and changes in the valuation allowance are included on the consolidated statements of income in other non-interest expense.

Stock-Based Compensation Plan: The Company's stock-based employee compensation plan for key officers is described more fully in Note 11.

In accordance with FASB ASC Topic 718-10, compensation expense for stock options awarded is recorded over the vesting period at the fair value of the stock options at the time of grant. The exercise price of stock options granted under the Company's incentive plan is equal to the fair market value of the underlying stock at the grant date. All stock option awards were fully vested prior to January 1, 2008 so no compensation expense was recorded in 2014 or 2013.

Compensation expense for awards of restricted stock and restricted stock units that settle in stock are recorded over the vesting period at the fair value of the Company's stock on the grant date. Compensation expense for stock-based compensation settled in cash is recorded over the vesting period with the liability adjusted for changes in the fair value of the Company's stock until settled.

Income Taxes: Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax basis of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

The Company may also recognize a liability for unrecognized tax benefits from uncertain tax positions. Unrecognized tax benefits represent the differences between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured in the financial statements. Interest and penalties related to unrecognized tax benefits are classified as income taxes, if applicable. No liabilities for unrecognized benefits from uncertain tax positions have been recorded. The tax years 2011, 2012, and 2013 are open for examination by the IRS and applicable state taxing authorities. The Company has not yet filed its income tax returns for the year ended December 31, 2014.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Derivative Instruments: Derivative financial instruments are recognized as assets and liabilities on the consolidated balance sheet and measured at fair value.

Loan Commitments: Derivatives include loan rate locks and forward delivery contracts. The Company enters into forward delivery contracts to offset the risk of issuing rate lock commitments to customers and the potential decrease in value of loans held for sale from changes in interest rates between the date that the rate lock commitments are issued and the date the loan is sold in the secondary market. These derivatives are reported at fair value in the consolidated balance sheet, with changes in the fair value of the derivatives being included in non-interest income. To the extent that the Company's forward contracts are highly effective, the changes in fair value will largely offset changes in the fair value of the held-for-sale mortgage loans and the loan commitments.

Earnings Per Share: Basic earnings per share excludes dilution, and is calculated by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period.

Diluted earnings per share is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding during the period increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. The dilutive effect of outstanding options is reflected in diluted earnings per share by application of the treasury stock method.

Earnings per common share have been computed for the years ended December 31, 2014 and 2013 based on the following:

	2014	2013
<i>Basic:</i>		
Net income, as reported	\$ 2,252	\$ 3,915
Preferred stock dividends and accretion of issuance discount	(194)	(645)
Net income available to common stockholders	\$ 2,058	\$ 3,270
Weighted average shares outstanding	2,226,131	2,209,944
Basic earnings per share	\$ 0.92	\$ 1.48
<i>Diluted:</i>		
Net income available to common stockholders	\$ 2,058	\$ 3,270
Weighted average shares outstanding	2,226,131	2,209,944
Effect of dilutive restricted stock units outstanding	22,700	21,417
Diluted weighted average shares outstanding	2,248,831	2,231,361
Diluted earnings per share	\$ 0.92	\$ 1.47

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Comprehensive Income: Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of accumulated other comprehensive income.

	December 31	
	2014	2013
Net unrealized gains on securities available for sale	\$ 3,118	\$ (383)
Tax effect	(1,187)	154
Net-of-tax amount	\$ 1,931	\$ (229)

Fair Value of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 17. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

Newly Issued not yet Effective Accounting Standards:

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-01, *Investments – Equity Method and Joint Ventures (Topic 323) – Accounting for Investments in Affordable Housing Projects*. The ASU permits entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the statement of operations as a component of income tax expense. This ASU is effective for reporting periods beginning after December 15, 2014 (therefore, for the year ending December 31, 2015 for the Company). Adoption of this update is not expected to have a material effect on the consolidated financial statements.

The FASB issued ASU 2014-04, *Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The ASU clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The ASU is effective for reporting periods beginning after December 15, 2014 (therefore, for the year ending December 31, 2015 for the Company). The ASU can be adopted using either a modified retrospective transition method or a prospective transition method. Adoption of this update is not expected to have a material effect on the consolidated financial statements.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 1. Nature of Business and Significant Accounting Policies (Continued)

The FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The ASU adopts a standardized approach for revenue recognition and was a joint effort with the International Accounting Standards Board (IASB). The new revenue recognition standard is based on a core principle of recognizing revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU does not apply to financial instruments. The ASU is effective for reporting periods beginning after December 15, 2016 (therefore, for the year ending December 31, 2017 for the Company). Early implementation is not allowed for public companies. Management is currently assessing the impact to the Corporation's consolidated financial statements.

In January 2014, the FASB issued ASU No. 2014-04, "*Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*". The primary purpose of this new guidance is to clarify, for residential mortgage loans, when an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a residential mortgage loan. This new accounting standard is effective for financial statements issued for annual periods beginning after December 15, 2014. The Company does not believe this will have a significant impact on its consolidated financial statements.

Reclassification: Certain amounts in the 2013 consolidated financial statements have been reclassified to conform to the 2014 presentation.

Subsequent Events: The Company has evaluated subsequent events for recognition and disclosure through March 6, 2015, which is the date the consolidated financial statements were available to be issued.

Note 2. Cash and Due From Banks

The Bank is required to maintain vault cash and reserve balances with Federal Reserve Bank based upon a percentage of deposits. These requirements approximated \$5,015 and \$5,742 at December 31, 2014 and 2013, respectively.

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)***Note 3. Securities – Available-for-Sale**

The amortized cost and estimated fair values of securities available-for-sale, with gross unrealized gains and losses at December 31, are summarized as follows:

	2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government-sponsored agencies	\$ 3,272	\$ 46	\$ 38	\$ 3,280
Obligations of states and political subdivisions	41,024	2,063	21	43,066
Asset-backed securities	3,305	27	53	3,279
Mortgage-backed securities-residential	30,621	532	11	31,142
Collateralized mortgage obligations	45,860	807	234	46,433
Marketable equity securities	1,984	-	-	1,984
	<u>\$ 126,066</u>	<u>\$ 3,475</u>	<u>\$ 357</u>	<u>\$ 129,184</u>

	2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government-sponsored agencies	\$ 2,467	\$ -	\$ 23	\$ 2,444
Obligations of states and political subdivisions	43,185	912	726	43,371
Asset-backed securities	3,854	43	153	3,744
Mortgage-backed securities-residential	33,697	810	283	34,224
Collateralized mortgage obligations	45,165	980	1,943	44,202
	<u>\$ 128,368</u>	<u>\$ 2,745</u>	<u>\$ 3,128</u>	<u>\$ 127,985</u>

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)*

Note 3. Securities – Available-for-Sale (Continued)

The amortized cost and estimated fair value of securities available-for-sale, by contractual maturity at December 31, 2014 is as follows:

	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 150	\$ 150
Due after one year through five years	8,953	9,362
Due after five years through ten years	10,755	11,171
Due after ten years	24,438	25,663
	<u>44,296</u>	<u>46,346</u>
Asset-backed securities	3,305	3,279
Mortgage-backed securities-residential	30,621	31,142
Collateralized mortgage obligations	45,860	46,433
Marketable equity securities	1,984	1,984
	<u>\$ 126,066</u>	<u>\$ 129,184</u>

Expected maturities may differ from contractual maturities on asset-backed securities, mortgage-backed securities, and collateralized mortgage obligations because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Gross gains of \$1,178 and \$2,816 were recorded on those sales for the years ended December 31, 2014 and 2013, respectively. Gross losses of \$538 and \$84 were recorded on those sales for the year ended December 31, 2014 and 2013, respectively.

Securities with a carrying value of approximately \$110,866 and \$106,813 as of December 31, 2014 and 2013, respectively, were pledged as collateral to the Federal Reserve Bank of Chicago, on public deposits and for other purposes as required or permitted by law.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 3. Securities – Available-for-Sale (Continued)

Unrealized losses and fair value, aggregated by investment category and length of time that individual securities available for sale have been in a continuous unrealized loss position, as of December 31, 2014 and 2013 are summarized as follows (dollar amounts only in thousands):

	Less than 12 months			12 Months or More		
	Estimated Number of Securities	Fair Value	Unrealized Losses	Estimated Number of Securities	Fair Value	Unrealized Losses
<u>December-2014</u>						
U.S. government-sponsored agencies	-	\$ -	\$ -	1	\$ 2,437	\$ 38
Obligations of states and political subdivisions	1	846	1	9	2,303	20
Asset-backed securities	1	23	-	2	2,757	53
Mortgage-backed securities-residential	2	2,189	2	2	5,494	9
Collateralized mortgage obligations	8	11,804	193	4	5,615	41
	<u>12</u>	<u>\$14,862</u>	<u>\$ 196</u>	<u>18</u>	<u>\$18,606</u>	<u>\$ 161</u>
<u>December-2013</u>						
U.S. government-sponsored agencies	1	\$ 2,444	\$ 23	-	\$ -	\$ -
Obligations of states and political subdivisions	45	17,190	547	5	2,011	179
Asset-backed securities	1	1,761	33	1	1,298	120
Mortgage-backed securities-residential	4	11,549	283	-	-	-
Collateralized mortgage obligations	11	15,359	648	10	5,144	1,295
	<u>62</u>	<u>\$48,303</u>	<u>\$ 1,534</u>	<u>16</u>	<u>\$ 8,453</u>	<u>\$ 1,594</u>

During 2014, the Company recorded OTTI losses of \$170 on five private-label collateralized mortgage obligations. The Company sold these securities during 2014, as such, there were no securities with OTTI losses at December 31, 2014. During 2013, the Company recorded OTTI losses of \$146 on two private-label collateralized mortgage obligations and two obligations of states and political subdivisions with carrying values of \$909 at December 31, 2013.

For all of the other available-for-sale securities, the unrealized losses have not been recognized into income because, based on management's evaluation, the decline in fair value is largely due to temporary market conditions and trading spreads, and, as such, are considered to be temporary by the Company. In addition, the Company's management has the intent and ability to hold these securities until they mature or the Company recovers their carrying values.

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)*

Note 3. Securities – Available-for-Sale (Continued)

The table below presents a rollforward of the OTTI losses recognized in earnings for the years ended December 31, 2014 and 2013:

	2014	2013
Beginning balance	\$ (1,597)	\$ (1,600)
Amounts related to credit loss for which an other-than temporary impairment was not previously recognized	-	(136)
Additions/subtractions		
Amounts realized for securities sold during the period	1,767	149
Amounts related to securities for which the company intends to sell or that it will be more likely than not that the company will be required to sell prior to recovery of amortized cost basis	-	-
Reductions for increase in cash flows expected to be collected that are recognized over the remaining life of the security	-	-
Increases to the amount related to the credit loss for which other-than-temporary was previously recognized	(170)	(10)
Ending balance	<u>\$ -</u>	<u>\$ (1,597)</u>

Note 4. Loans

Major classifications of loans as of December 31, are as follows:

	2014	2013
Commercial real estate and construction	\$ 154,383	\$ 154,508
Commercial and industrial	134,264	126,639
Residential real estate	97,428	94,251
Consumer and other	9,769	11,791
	<u>395,844</u>	<u>387,189</u>
Less allowance for loan losses	4,396	4,894
Net loans	<u>\$ 391,448</u>	<u>\$ 382,295</u>

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 4. Loans (Continued)

The following tables present the balance in the allowance for loan losses and the recorded investment in loans based on portfolio segment and impairment method as of December 31:

	Commercial Real Estate and Construction	Commercial and Industrial	Residential Real Estate	Consumer and Other	Total
2014					
Beginning balance	\$ 1,137	\$ 843	\$ 2,588	\$ 326	\$ 4,894
Provision for loan losses	1,151	(17)	1,208	(57)	2,285
Charge-offs	(1,054)	(479)	(1,406)	(230)	(3,169)
Recoveries	61	5	197	123	386
Ending balance	<u>\$ 1,295</u>	<u>\$ 352</u>	<u>\$ 2,587</u>	<u>\$ 162</u>	<u>\$ 4,396</u>
<u>Allowance for loan losses:</u>					
Individually evaluated for impairment	\$ 298	\$ 3	\$ 741	\$ -	\$ 1,042
Collectively evaluated for impairment	997	349	1,846	162	3,354
Totals	<u>\$ 1,295</u>	<u>\$ 352</u>	<u>\$ 2,587</u>	<u>\$ 162</u>	<u>\$ 4,396</u>
<u>Loans:</u>					
Individually evaluated for impairment	\$ 4,235	\$ 182	\$ 11,432	\$ 1,350	\$ 17,199
Collectively evaluated for impairment	150,148	134,082	85,996	8,419	378,645
Totals	<u>\$ 154,383</u>	<u>\$ 134,264</u>	<u>\$ 97,428</u>	<u>\$ 9,769</u>	<u>\$ 395,844</u>

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 4. Loans (Continued)

	Commercial Real Estate and Construction	Commercial and Industrial	Residential Real Estate	Consumer and Other	Total
2013					
Beginning balance	\$ 2,475	\$ 1,062	\$ 2,695	\$ 288	\$ 6,520
Provision for loan losses	1,627	708	1,667	139	4,141
Charge-offs	(3,495)	(940)	(1,890)	(266)	(6,591)
Recoveries	530	13	116	165	824
Ending balance	<u>\$ 1,137</u>	<u>\$ 843</u>	<u>\$ 2,588</u>	<u>\$ 326</u>	<u>\$ 4,894</u>

Allowance for loan losses:

Individually evaluated for impairment	\$ 157	\$ 44	\$ 363	\$ -	\$ 564
Collectively evaluated for impairment	980	799	2,225	326	4,330
Totals	<u>\$ 1,137</u>	<u>\$ 843</u>	<u>\$ 2,588</u>	<u>\$ 326</u>	<u>\$ 4,894</u>

Loans:

Individually evaluated for impairment	\$ 4,001	\$ 938	\$ 10,700	\$ 4,094	\$ 19,733
Collectively evaluated for impairment	150,507	125,701	83,551	7,697	367,456
Totals	<u>\$ 154,508</u>	<u>\$ 126,639</u>	<u>\$ 94,251</u>	<u>\$ 11,791</u>	<u>\$ 387,189</u>

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)***Note 4. Loans (Continued)**

Detailed information regarding impaired loans for the year ended December 31, follows:

2014

	Recorded Investment	Principal Balance	Related Allowance	Average Investment	Interest Recognized
Loans with no related Allowance for Loan Loss:					
Commercial real estate and construction	\$ 2,477	\$ 4,425	\$ -	\$ 3,107	\$ 52
Commercial and industrial	179	329	-	432	3
Residential real estate	5,093	5,315	-	8,360	299
Consumer and other	1,350	3,808	-	1,920	89
Totals	9,099	13,877	-	13,819	443
Loans with an Allowance for Loan Loss:					
Commercial real estate and construction	1,758	1,853	298	1,039	17
Commercial and industrial	3	3	3	94	1
Residential real estate	6,339	6,768	741	2,286	82
Consumer and other	-	-	-	-	-
Totals	8,100	8,624	1,042	3,419	100
Grand totals	\$ 17,199	\$ 22,501	\$ 1,042	\$ 17,238	\$ 543

2013

	Recorded Investment	Principal Balance	Related Allowance	Average Investment	Interest Recognized
Loans with no related Allowance for Loan Loss:					
Commercial real estate and construction	\$ 2,958	\$ 5,396	\$ -	\$ 6,135	\$ 178
Commercial and industrial	836	1,108	-	2,398	76
Residential real estate	9,410	10,336	-	8,302	300
Consumer and other	4,094	4,094	-	1,383	67
Totals	17,298	20,934	-	18,218	621
Loans with an Allowance for Loan Loss:					
Commercial real estate and construction	1,043	1,397	157	4,239	123
Commercial and industrial	102	102	44	422	13
Residential real estate	1,290	1,604	363	1,343	49
Consumer and other	-	-	-	1	-
Totals	2,435	3,103	564	6,005	185
Grand totals	\$ 19,733	\$ 24,037	\$ 564	\$ 24,223	\$ 806

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 4. Loans (Continued)

The Bank regularly monitors the credit quality of its loans and evaluates various attributes of loans to determine the appropriateness of the allowance for loan losses. The credit quality indicators monitored differ depending on the class of loan.

For loans with commercial credit exposure, the Bank generally evaluates using the following internally prepared ratings:

“Pass” ratings are assigned to loans with adequate collateral and debt service ability such that collectability of the contractual loan payments is highly probable.

“Special Mention” ratings are assigned to loans or loan relationships where management has some concern that collateral or debt service ability may not be adequate, though the collectability of the contractual loan payments is still probable. Borrowers may be experiencing adverse operating trends (declining revenues or margins) or increasing leverage position. Adverse economic or market conditions, such as interest rate increases or the entry of a new competitor, may also support a special mention rating. Nonfinancial reasons for rating a credit exposure special mention include management problems, pending litigation, and business structural weaknesses.

“Substandard” ratings are assigned to loan or loan relationships that do not have adequate collateral and/or debt service ability such that collectability of the contractual loan payments is no longer probable. Loans so classified have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt by the borrower and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Substandard loans typically require more intensive supervision by management. For some substandard loans, the likelihood of full collection of interest and principal may be in doubt and thus, placed on nonaccrual.

“Doubtful” ratings are assigned to loans or loan relationships that do not have adequate collateral and/or debt service ability, and collectability of the contractual loan payment is unlikely. A doubtful loan has a high probability of total or substantial loss, but because of specific pending events that may strengthen the loan, its classification as loss is deferred. Doubtful borrowers are usually in default, lack adequate liquidity or capital, and lack resources necessary to remain an operating entity. Pending events can include mergers, acquisitions, liquidations, capital injections, the perfection of liens on additional collateral, and refinancing or restructure.

Residential real estate and Consumer and other loans are generally evaluated based on whether or not the loan is performing according to the contractual terms of the loan. The Bank considers residential real estate and consumer and other loans that are on nonaccrual status, over ninety days past due, have had a partial write down, or have been modified in a troubled debt restructuring to be classified as impaired.

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)*

Note 4. Loans (Continued)

Information regarding the credit quality indicators most closely monitored for the years ended December 31, follows:

2014

	Pass	Special Mention	Substandard	Doubtful	Totals
Commercial Credit Exposure:					
Commercial real estate and construction	\$ 138,182	\$ 11,321	\$ 4,880	\$ -	\$ 154,383
Commercial and industrial	127,388	4,454	2,422	-	134,264
Totals	<u>\$ 265,570</u>	<u>\$ 15,775</u>	<u>\$ 7,302</u>	<u>\$ -</u>	<u>\$ 288,647</u>

	Performing	Impaired	Totals
Residential and Consumer Credit Exposure:			
Residential real estate	\$ 85,996	\$ 11,432	\$ 97,428
Consumer and other	8,419	1,350	9,769
Totals	<u>\$ 94,415</u>	<u>\$ 12,782</u>	<u>\$ 107,197</u>

2013

	Pass	Special Mention	Substandard	Doubtful	Totals
Commercial Credit Exposure:					
Commercial real estate and construction	\$ 135,489	\$ 13,215	\$ 5,804	\$ -	\$ 154,508
Commercial and industrial	116,234	5,543	4,862	-	126,639
Totals	<u>\$ 251,723</u>	<u>\$ 18,758</u>	<u>\$ 10,666</u>	<u>\$ -</u>	<u>\$ 281,147</u>

	Performing	Impaired	Totals
Residential and Consumer Credit Exposure:			
Residential real estate	\$ 83,551	\$ 10,700	\$ 94,251
Consumer and other	7,697	4,094	11,791
Totals	<u>\$ 91,248</u>	<u>\$ 14,794</u>	<u>\$ 106,042</u>

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)***Note 4. Loans (Continued)**

Loan aging information for the years ended December 31, follows:

2014

	30-89 Days	90+ Days	Total Past Due	Current	Total Loans	90+ and Accruing	Nonaccrual Loans
Commercial real estate and construction	\$ 703	\$ 738	\$1,441	\$152,942	\$154,383	\$ -	\$ 2,440
Commercial and industrial	494	71	565	133,699	134,264	-	148
Residential real estate	655	1,612	2,267	95,161	97,428	-	3,065
Consumer and other	12	25	37	9,732	9,769	-	25
Totals	\$1,864	\$2,446	\$4,310	\$391,534	\$395,844	\$ -	\$ 5,678

2013

	30-89 Days	90+ Days	Total Past Due	Current	Total Loans	90+ and Accruing	Nonaccrual Loans
Commercial real estate and construction	\$ 573	\$1,850	\$2,423	\$152,085	\$154,508	\$ -	\$ 3,315
Commercial and industrial	1,347	589	1,936	124,703	126,639	-	903
Residential real estate	2,323	1,165	3,488	90,763	94,251	-	2,084
Consumer and other	10	8	18	11,773	11,791	-	11
Totals	\$4,253	\$3,612	\$7,865	\$379,324	\$387,189	\$ -	\$ 6,313

When, for economic or legal reasons related to the borrower's financial difficulties, the Company grants a concession to the borrower that the Company would not otherwise consider, the modified loan is classified as a trouble debt restructuring. Loan modifications may consist of forgiveness of interest and/or principal, a reduction of the interest rate, interest-only payments for a period of time, and/or extending amortization terms. The following tables present information regarding modifications of loans that are classified as troubled debt restructurings during the years ended December 31, 2014 and 2013. All troubled debt restructurings are classified as impaired loans. The recorded investment presented in the following tables do not include specific reserves for loan losses recognized for these loans, which totaled \$26 and \$37 at December 31, 2014 and 2013, respectively. The Bank has committed to lend additional amounts totaling up to \$0 and \$1,603 as of December 31, 2014 and 2013, respectively to customers with outstanding loans that are classified as troubled debt restructurings.

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)*

Note 4. Loans (Continued)2014

	Number of Contracts	Pre-Modification Investment	Post-Modification Investment
New troubled debt restructurings:			
Commercial real estate and construction	1	\$ 781	\$ 781
Residential real estate	2	153	130
Totals	3	\$ 934	\$ 911

2013

	Number of Contracts	Pre-Modification Investment	Post-Modification Investment
New troubled debt restructurings:			
Residential real estate	3	\$ 233	\$ 241

The Bank considers a troubled debt restructured loan in default if the loan becomes 90 days or more past due. The following tables summarize troubled debt restructurings that defaulted during the year ended December 31, 2014, within 12 months of their modification date. If troubled debt restructurings default, the loans are reevaluated for impairment consistent with impaired loan accounting policies.

2014

	Number of Contracts	Recorded Investment
Troubled debt restructurings that defaulted:		
Residential real estate	1	\$ 58
Totals	1	\$ 58

There were no troubled debt restructurings that defaulted in 2013 within 12 months of their modification date.

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)*

Note 5. Premises and Equipment

Premises and equipment at December 31 are summarized as follows:

	2014	2013
Land and improvements	\$ 3,359	\$ 3,376
Buildings and improvements	8,441	8,997
Furniture and equipment	9,203	10,122
	<u>21,003</u>	<u>22,495</u>
Less accumulated depreciation	12,683	13,573
	<u>8,320</u>	<u>8,922</u>
Premises and equipment, net	\$ 8,320	\$ 8,922

Note 6. Mortgage Servicing Rights

The following is a summary of changes in the balance of mortgage servicing rights for the years ended December 31:

	2014	2013
Balance at beginning	\$ 3,066	\$ 3,073
Additions	464	1,074
Amortization	<u>(890)</u>	<u>(1,081)</u>
Balance at end	<u>\$ 2,640</u>	<u>\$ 3,066</u>
Fair value at end of year	<u>\$ 4,129</u>	<u>\$ 4,193</u>

Loans serviced for others are not included in the consolidated balance sheets. The unpaid principal balances of mortgage loans serviced for others were \$450,372 and \$454,706 at December 31, 2014 and 2013, respectively.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 7. Investment in Affordable Housing Partnership

The Bank has invested in a limited partnership that was formed to develop and operate apartments designed as high-quality affordable housing for lower income tenants in the City of Beloit, Wisconsin. At December 31, 2014 and 2013, respectively, the Bank's net carrying value in the partnership was \$2,027 and \$2,147 and is included in other assets. Based on the Bank's approximately 40% ownership, the affordable housing partnership investment is accounted for using the equity method, and thus, the proportional net earnings (loss) from the limited partnership have been recognized in the net carrying value of the investment and in the consolidated statements of income.

The partnership must meet the regulatory requirements for affordable housing for a minimum 15-year compliance period to fully utilize the tax credits. If the partnership ceased to qualify during the compliance period, the credits may be denied for any period in which the project is not in compliance and a portion of the credits previously taken may be subject to recapture with interest. The Company's management believes the partnership is in compliance with the requirements at December 31, 2014 and 2013, respectively.

Note 8. Deposits

Deposits consisted of the following at December 31:

	2014	2013
Transaction accounts:		
Noninterest-bearing	\$ 99,068	\$ 91,450
Interest-bearing	158,692	158,636
Savings deposits	54,167	47,034
Money market investment accounts	110,811	106,997
Time deposits and certificate accounts	93,046	106,641
	<u>\$ 515,784</u>	<u>\$ 510,758</u>

The aggregate amount of time deposits, each with a minimum denomination of \$250, was approximately \$19,414 and \$21,319 at December 31, 2014 and 2013, respectively.

At December 31, 2014, the scheduled maturities of time deposits were as follows for years ending December 31:

2015	\$ 59,410
2016	16,085
2017	8,839
2018	4,984
2019	3,728
	<u>\$ 93,046</u>

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 9. Borrowings

Borrowed funds consisted of the following at December 31:

	2014		2013	
	Rates	Amount	Rates	Amount
FHLB advances	0.00%	\$ -	1.02%	\$ 10,157
Senior secured term note	4.00%	9,000		-
		<u>\$ 9,000</u>		<u>\$ 10,157</u>

At December 31, 2014, there were no outstanding FHLB advances. At December 31, 2013, the total outstanding balances of the FHLB advances included a \$157 fair value option adjustment for the one advance the Bank elected to carry at fair value.

The Bank has a master contract agreement with the FHLB which provides for the pledging of Bank assets as collateral for borrowing FHLB advances. The FHLB applies a discount or margin percentage to the total assets depending on the type of collateral. FHLB provides both fixed and floating rate advances. Floating rates are based on short-term market rates of interest. Fixed rate advances are priced at market rates of interest at the time of the advance, namely the rates that FHLB charges to borrowers at various maturities.

At December 31, 2014 and 2013, the Bank pledged collateral with a carrying value of \$77,320 and \$97,594, respectively, to the FHLB to secure advances.

In April 2014, the Company borrowed \$9,000 from a commercial bank. The loan is secured by 100% of the outstanding common stock of the Bank and has an interest rate of prime plus 0.75%, which can reset quarterly. Payments are made quarterly, with interest only paid until July 2015. The senior secured term loan matures in April 2019. The Company previously had a senior secured term note with a different commercial bank which was paid off at the maturity date of March 26, 2013.

At December 31, 2014 the contractual maturities of the senior secured term note are as follows:

2015	\$ 500
2016	1,000
2017	1,000
2018	1,000
2019	<u>5,500</u>
	<u>\$ 9,000</u>

The Bank also has a line of credit borrowing arrangement with the Federal Reserve Bank of Chicago with a potentially available advance limit based on the total collateral pledged. The line of credit is presently secured by pledged securities with an estimated fair value of \$39,819 and \$40,574 as of December 31, 2014 and 2013, respectively. The balance was \$0 at December 31, 2014 and 2013, respectively.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 10. Subordinated Debentures and Notes

In December 2002, the Company issued \$7,217 of subordinated debentures to Blackhawk Statutory Trust I, a special purpose entity that was formed solely to hold the subordinated debentures. This special purpose entity was capitalized by issuing 7,000 shares, totaling \$7,000, of Company Obligated Mandatorily Redeemable Preferred Securities and 217 shares, or \$217, of common ownership shares. The Company purchased 100% of the common ownership shares and the preferred shares were issued to unrelated parties. In December 2007, the Company redeemed \$6,186 of the subordinated debentures originally issued. The terms of the subordinated debentures are identical to the terms of the common and preferred securities. Distributions are paid quarterly. Cumulative cash distributions are calculated at three month LIBOR plus 3.25 percentage points, adjusted quarterly. The Company may, at one or more times defer interest payments on the subordinated debentures for up to 20 consecutive quarters, but not beyond December 26, 2032. At the end of any deferral period, all accumulated and unpaid distributions will be paid. The subordinated debentures, if still outstanding, must be redeemed on December 26, 2032; however, beginning on December 26, 2007, the Company has the option to redeem the debentures on a quarterly basis. The redemption price is at par plus any accrued and unpaid distribution to the date of redemption. The Company elected to carry the remaining balance of this subordinated debenture at fair value, which was \$1,031 at December 31, 2014 and at December 31, 2013.

In March 2005, the Company issued \$4,124 of subordinated debentures to Blackhawk Statutory Trust II, a special purpose entity that was formed solely to hold the subordinated debentures. This special purpose entity was capitalized by issuing 4,000 shares, totaling \$4,000, of Company Obligated Mandatorily Redeemable Preferred Securities and 124 shares, or \$124, of common ownership shares. The Company purchased 100% of the common ownership shares and the preferred shares were issued to unrelated parties. The terms of the subordinated debentures are identical to the terms of the common and preferred securities. Distributions are paid quarterly. Cumulative cash distributions are calculated at 6.57% through March 2010, after that the cash distributions are calculated at three-month LIBOR plus 2.05 percentage points, adjusted quarterly. The Company may, at one or more times defer interest payments on the subordinated debentures for up to 20 consecutive quarters, but not beyond March 17, 2035. At the end of any deferral period, all accumulated and unpaid distributions will be paid. The subordinated debentures must be redeemed on March 17, 2035; however, the Company has the option to redeem them on a quarterly basis beginning on March 17, 2010. The redemption price is at par plus any accrued and unpaid distribution to the date of redemption. The subordinated debentures are unsecured and rank junior in priority of payment to all of the Company's indebtedness and senior to the Company's capital stock. The balance at December 31, 2014 and 2013 was \$4,124.

The subordinated debentures are included in the balance sheet as liabilities; however, for regulatory purposes they are allowed in the calculation of Tier 1 and Tier 2 capital up to certain limits. In accordance with FASB Topic ASC 810-10 the trusts are not consolidated with the Company.

In March 2013, the Company issued subordinated notes with an aggregate principal balance of \$6,100 to certain related party accredited investors pursuant to a private placement memorandum. The notes are unsecured and bear interest at a fixed rate of 7.5% with interest payments due semi-annually, in arrears, in June and December. The principal balance and any accrued and unpaid interest is due in March 2023 when the notes mature. Beginning in March 2015, the Company may redeem the notes, in whole or in part, at a redemption price equal to 100% of the outstanding principal amount plus accrued and unpaid interest, provided, however, that any such redemption will require the prior approval of the Federal Reserve.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 11. Stock Based Compensation

The Company maintains an Equity Incentive Plan (the Plan) under which the Company may grant non-qualified stock options, stock appreciation rights, stock awards and cash incentive awards to its employees, directors or service providers. Under the 2008 Equity Incentive Plan, a total of 200,000 shares of the Company's common stock were reserved for issuance under the plan. The exercise price of an option or stock appreciation right may not be less than the fair market value of the Company's common stock on the date of grant.

The Company has issued three different types of awards under the plan, including: restricted stock, restricted stock units that settle with stock, and restricted stock units that settle in cash. The following table summarizes activity in the shares of the Company's common stock reserved for future issuance:

	2014	2013
Shares reserved, beginning of year	117,171	145,077
Stock awards issued	(17,233)	(27,906)
Stock awards forfeited	453	-
Shares reserved, end of year	100,391	117,171

As of December 31, 2014, there was \$355 of total unrecognized compensation costs related to following nonvested restricted awards granted under the Plan. The cost is expected to be recognized over a weighted-average period of 1.33 years.

The restricted stock issued under the plan vests over various time periods ranging from one to five years from the date of grant. The value of the restricted stock on the date of grant is amortized to expense over the vesting period. The following table summarizes restricted stock activity:

	2014		2013	
	Shares	Weighted Average Price	Shares	Weighted Average Price
Restricted shares, beginning of year	34,464	\$ 7.53	27,035	\$ 6.42
Restricted stock shares issued	12,703	13.00	20,492	8.40
Restricted stock shares fully vested and distributed	(16,372)	6.58	(13,063)	6.59
Restricted shares, end of year	30,795	\$ 10.29	34,464	\$ 7.53

Compensation expense recognized on restricted stock grants was \$126 and \$83 for the years ended December 31, 2014 and 2013 respectively.

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)*

Note 11. Stock Based Compensation (Continued)

Restricted stock units that settle in stock have been issued to directors as part of their annual retainer. These restricted stock units vest on the earlier of one year from date of issue or the next annual shareholders meeting. Each stock settle restricted stock entitles the holder to one share of the Company's common stock. The awards are payable upon termination of service with the Company. The following table summarizes activity related to restricted stock units that settle in stock.

	2014		2013	
	Weighted Average		Weighted Average	
	Shares	Price	Shares	Price
Restricted stock units, beginning of year	23,089	\$ 8.57	15,675	\$ 8.42
Restricted stock units issued	4,530	13.25	7,414	8.90
Restricted stock units settled	(6,297)	8.57	-	-
Units forfeited	(453)	13.25	-	-
Restricted stock units, end of year	20,869	\$ 9.49	23,089	\$ 8.57
Fully vested at end of year	16,792	\$ 8.57	15,675	\$ 8.42

The Company recognized \$66 of compensation expense in 2014 and 2013, related to the restricted stock units that settle in stock.

Restricted stock units that settle in cash are expensed over the vesting period. The value of this award is paid in cash on the vesting date. The value of these restricted stock units is expensed over the vesting period with the liability to settle the awards continually adjusted based on the Company's stock price until the awards are settled in cash.

The Company issued 12,225 and 3,640 cash settle restricted stock units during 2014 and 2013, respectively. The Company recognized \$176 and \$84 of compensation expense related to restricted stock units that settle in cash for the years ending December 31, 2014 and 2013, respectively.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 11. Stock Based Compensation (Continued)

The following table summarizes the activity of options exercised or forfeited for the years ended December 31:

	2014				2013			
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Shares under option, beginning of year	-	\$ -	-	\$ -0-	51,000	\$ 11.48	0.77	\$ -0-
Granted during the year	-	-	-	-	-	-	-	-
Expired during the year	-	-	-	-	(49,500)	11.47	-	-
Forfeited during the year	-	-	-	-	(1,500)	11.92	-	-
Exercised during the year	-	-	-	-	-	-	-	-
Shares under option, end of year	-	\$ -	-	\$ -0-	-	\$ -	-	\$ -0-
Options exercisable, end of year	-	\$ -	-	\$ -0-	-	\$ -	-	\$ -0-

Note 12. Income Taxes

The provision for income taxes included in the accompanying consolidated financial statements for the years ended December 31, consisted of the following:

	2014	2013
Current tax provision (benefit):		
Federal	\$ 1,091	\$ (399)
State	473	237
	<u>1,564</u>	<u>(162)</u>
Deferred tax (benefit) provision:		
Federal	(1,328)	929
State	(199)	162
	<u>(1,527)</u>	<u>1,091</u>
Change in valuation allowance	<u>(22)</u>	<u>(22)</u>
Total provision for income taxes	<u>\$ 15</u>	<u>\$ 907</u>

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 12. Income Taxes (Continued)

The net deferred tax assets included in other assets in the consolidated balance sheets includes the following amounts of gross deferred tax assets and liabilities as of December 31:

	2014	2013
Gross deferred tax assets	\$ 4,322	\$ 3,880
Gross deferred tax liabilities	(3,504)	(3,247)
	818	633
Valuation allowance	(377)	(399)
Net deferred tax asset	\$ 441	\$ 234

The temporary differences that resulted in significant gross deferred tax assets and liabilities above are the allowance for loan losses, the repurchase agreement fraud (as discussed in Note 22), the amortization of mortgage servicing rights, and unrealized gain/losses on securities available-for-sale.

Taxable income differs from net income principally by income on tax-exempt securities and loans, low income housing credits, and increases in cash surrender value of bank-owned life insurance. The Company has \$4,772 and \$5,053 of State net operating loss carryforwards that expire in 2031 for the years ended December 31, 2014 and 2013, respectively. Because of uncertainty in being able to estimate the availability of future state taxable income to adequately absorb these loss carryforwards, management has recorded a valuation allowance equal to the amount of these deferred tax benefits.

Note 13. Employee Benefit Plans

Retirement Plan: The Bank has a 401(k) plan whereby eligible employees have the option to participate in the plan. Employees may contribute up to 15 percent of their compensation subject to certain limits based on federal tax laws. The Bank makes matching contributions equal to 100 percent of the first 3 percent of an employee's compensation contributed, and 50 percent of the next 2 percent of an employee's compensation contributed to the 401(k) plan. Additionally, the Bank may make a discretionary profit sharing contribution. Matching contributions vest immediately to the employee. For the years ended December 31, 2014 and 2013, contributions to the 401(k) plan amounted to approximately \$248 and \$250, respectively.

Deferred Compensation: As a result of acquisitions, the Bank assumed deferred compensation agreements with certain former executive officers of the acquired banks. Amounts due under these deferred compensation agreements, which are fully vested, are accumulated in an account from which benefits are being paid or will be paid over a period 15 years beginning when the former executive officers attains the age of 65. In 2011, a new plan became effective for executive officers and directors of the Company that allows them to elect to defer compensation. The amounts due under this plan are accumulated in an account from which the executive officers and directors will be paid. Amounts due under this plan are paid at the earlier of six months after separation of service from the company or on dates selected by the participant when making the election to defer compensation. As of December 31, 2014 and 2013, the recorded deferred compensation liability totaled \$753 and \$720, respectively. Total expense for 2014 and 2013 was \$89 and \$72, respectively.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 14. Related Party Transactions

Certain directors, executive officers and significant shareholders of the Company, and their related interests, had loans outstanding in the aggregate amounts of approximately \$24,816 and \$26,722 at December 31, 2014 and 2013, respectively. These loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other persons and did not involve more than normal risks of being collectible.

Deposit accounts from these related parties totaled \$32,963 and \$27,385 at December 31, 2014 and 2013, respectively.

Note 15. Commitments and Contingencies

Legal Contingencies: In the normal course of business, the Company is involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material adverse effect on the consolidated financial statements.

Credit-Related Financial Instruments: The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business. These off-balance sheet financial instruments consist of commitments to extend credit and letters of credit issued to meet customer-financing needs. Loan commitments are recorded when they are funded. They involve, to varying degrees, elements of credit risk in excess of amounts recognized on the consolidated balance sheets.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Company uses the same credit policies in making commitments and issuing letters of credit as they do for on-balance-sheet instruments.

Off-balance-sheet financial instruments, whose contracts represented credit and/or interest rate risk at December 31, are as follows:

	2014	2013
Unfunded commitments under lines of credit	\$ 78,590	\$ 72,756
Standby letters of credit	3,312	2,898
Commitments to extend credit:		
Commercial	17,195	2,790
Residential	7,195	4,409

Unfunded commitments under commercial lines of credit, revolving credit lines, and overdraft protection agreements are commitments for possible future extensions of credit to existing customers.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 15. Commitments and Contingencies (Continued)

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third-party. Those guarantees are primarily issued to support public and private borrowing arrangements and, generally, have terms of one year or less. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties. In the event the customer does not perform in accordance with the terms of the agreement with the third-party, the Bank would be required to fund the commitment. The maximum potential amount of future payments the Bank could be required to make is represented by the contractual amount shown in the summary above. If the commitment is funded, the Bank would be entitled to seek recovery from the customer. At December 31, 2014 and 2013, no amounts have been recorded as liabilities for the Bank's potential obligations under these guarantees.

Lease Commitments: The Bank leases three office locations under non-cancelable operating leases. One lease expires in April 2018 and is subject to an annual 3% inflationary adjustment. One lease expires June 2015 with the Bank having the option to extend the lease to June 2018. The third lease expires in May 2017 with the Bank having the option to purchase. Under each of these leases the Bank is responsible for property taxes, utilities and maintenance.

The Bank also leases certain office equipment under short-term agreements which are not deemed significant.

At December 31, 2014, the future minimum lease payments under the Bank's contractual operating leases (in thousands) are as follows for the years ending December 31:

2015	\$ 110
2016	88
2017	90
2018	30
	\$ 318

Total rent expense for the years ended December 31, 2014 and 2013 amounted to \$186 and \$157, respectively.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 16. Regulatory Capital Requirements and Restrictions on Payment of Dividends

The Company (on a consolidated basis) and Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table on the following page) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2014 and 2013, that the Company and the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2014, the most recent notification of the regulatory agencies categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since these notifications that management believes have changed the Bank's category.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 16. Regulatory Capital Requirements and Restrictions on Payment of Dividends (Continued)

The actual capital amounts and ratios for the Company and the Bank are presented in the following table as of December 31:

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Amounts in thousands)						
As of December 31, 2014:						
Total capital						
to risk-weighted assets:						
Company	\$ 50,719	11.9%	\$ 34,004	8.0%	NA	NA
Bank	58,076	13.7	33,976	8.0	\$ 42,470	10.0%
Tier 1 capital						
to risk-weighted assets:						
Company	40,223	9.5	17,002	4.0	NA	NA
Bank	53,680	12.6	16,988	4.0	25,482	6.0
Tier 1 capital						
to average assets:						
Company	40,223	7.0	22,926	4.0	NA	NA
Bank	53,680	9.4	22,905	4.0	28,631	5.0
As of December 31, 2013:						
Total capital						
to risk-weighted assets:						
Company	\$ 59,444	13.9%	\$ 34,263	8.0%	NA	NA
Bank	57,877	13.5	34,243	8.0	\$ 42,804	10.0%
Tier 1 capital						
to risk-weighted assets:						
Company	48,624	11.4	17,131	4.0	NA	NA
Bank	52,983	12.4	17,121	4.0	25,682	6.0
Tier 1 capital						
to average assets:						
Company	48,624	8.4	23,189	4.0	NA	NA
Bank	52,983	9.1	23,175	4.0	28,969	5.0

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 16. Regulatory Capital Requirements and Restrictions on Payment of Dividends (Continued)

In 2013, the federal banking agencies issued revisions to the existing capital rules to incorporate certain changes to the Basel capital framework, including Basel III and other elements. The intent is to strengthen the definition of regulatory capital, increase risk-based capital requirements, and make selected changes to the calculation of risk-weighted assets. Beginning January 1, 2015, banks transitioned to the new rules and will report results with the first call report of 2015. As part of the new rules there are several provisions affecting the Bank, such as the implementation of a new common equity tier 1 ratio, a capital conservation buffer, and increased prompt corrective action capital adequacy thresholds. As of December 31, 2014, management believes the Bank's capital level exceeds the increased Basel III prompt corrective action capital adequacy thresholds.

A source of income and funds of the Company are dividends from the Bank. Current banking law limits the amount of dividends banks can pay. Regardless of formal regulatory restrictions, the Bank may not pay dividends which would result in its capital levels being reduced below the minimum requirements shown above.

Note 17. Fair Value of Financial Instruments

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best-determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

Cash and Cash Equivalents: The carrying amounts of cash and due from banks approximate their fair values.

Securities Available-for-Sale: Fair values of securities available-for-sale are based on quoted market prices. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Federal Home Loan Bank Stock: The carrying amount approximates fair value.

Loans: For variable-rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for all other loans are estimated by discounting contractual cash flows using estimated market discount rates which reflect the credit and interest rate risk inherent in the loan. Fair values for impaired loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Loans Held for Sale: Fair value of loans held for sale is determined by reference to current loan pricing being quoted by third party investors.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 17. Fair Value of Financial Instruments (Continued)

Mortgage Servicing Rights: Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of net servicing income. This calculation considers estimates of future serving income, the cost to service, custodial earnings rate, prepayment speeds and default rates.

Accrued Interest Receivable and Payable: The carrying amounts of accrued interest receivable and payable approximate their fair values.

Deposits: The fair values disclosed for non-maturing deposits (interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates of similar remaining maturities.

FHLB Advances: The carrying amounts of short-term borrowings approximates fair value.

Senior Secured Term Loan: The fair value is estimated using discounted cash flow analysis based on current interest rates being offered on instruments with similar terms and credit quality.

Subordinated Debentures and Notes: The fair values are estimated at the cost to redeem them.

Other Derivative Assets and Liabilities: Derivatives instruments such as interest rate lock commitments and forward contracts are valued by means of pricing models based on readily observable market parameters such as interest rate yield curves and option pricing volatilities.

Off-Balance-Sheet Instruments: The estimated fair value of fee income on letters of credit at December 31, 2014 and 2013 is not material. Loan commitments on which the committed interest rate is less than the current market rate are also not material at December 31, 2014 and 2013.

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)*

Note 17. Fair Value of Financial Instruments (Continued)

The estimated fair values of the Company's financial instruments at December 31 are as follows:

	2014		2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<i>Financial Assets:</i>				
Cash and cash equivalents	\$ 21,591	\$ 21,591	\$ 34,492	\$ 34,492
Securities available-for-sale	129,184	129,184	127,985	127,985
Loans held for sale, net	1,537	1,541	1,161	1,163
Loans, net	391,448	395,782	382,295	389,033
Federal Home Loan Bank Stock	2,266	2,266	2,266	2,266
Accrued interest receivable	1,694	1,694	1,805	1,805
Mortgage servicing rights	2,640	4,129	3,066	4,193
Derivative assets	5	5	33	33
<i>Financial Liabilities:</i>				
Non-interest bearing deposits	\$ 99,068	\$ 99,068	\$ 91,450	\$ 91,450
Interest bearing deposits	416,716	417,024	419,308	420,835
FHLB advances	-	-	10,157	10,157
Senior secured term note	9,000	9,000	-	-
Subordinated debentures and notes	11,255	11,255	11,255	11,255
Accrued interest payable	253	253	256	256
Other derivative liabilities	9	9	14	14

Blackhawk Bancorp, Inc. and Subsidiary

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Note 18. Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy established according to accounting standards requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring the fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1 – Quoted prices for identical assets or liabilities in active markets that the Company has the ability to access as of the measurement date.
- Level 2 – Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 – Significant unobservable inputs that reflect the Company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Impaired Loans: The Company does not record loans at fair value on a recurring basis. However, from time to time, fair value adjustments are recorded on these loans to reflect (1) partial write-downs, through charge-offs or specific reserve allowances, that are based on the current appraised or market-quoted value of the underlying collateral or (2) based on the present value of expected future cash flows discounted at the applicable effective interest rate. In some cases, the properties for which market quotes or appraised values have been obtained are located in areas where comparable sales data is limited, outdated, or unavailable. Fair value estimates for collateral-dependent impaired loans are obtained from real estate brokers or other third-party consultants. Adjustments are routinely made in the appraisal process by independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically results in a Level 3 classification. Non-real estate collateral may be valued using an appraisal, net book value of the borrower's financial statements or aging reports, adjusted or discounted based on management's expertise and knowledge of the borrower and comparisons to sales of comparable assets, but include significant unobservable data and are therefore considered Level 3 measurements.

Foreclosed Assets: Real estate acquired through or in lieu of loan foreclosure are not measured at fair value on a recurring basis. However, other real estate is initially measured at fair value (less estimated costs to sell) when it is acquired and may also be measured at fair value (less estimated costs to sell) if it becomes subsequently impaired. The fair value measurement for each property may be obtained from an independent appraiser or prepared internally. Fair value measurements obtained from independent appraisers generally utilize a market approach based on sales of comparable assets and/or an income approach. Such measurements are usually considered Level 2 measurements. Management routinely evaluates fair value measurements of independent appraisers by comparing actual selling prices to the most recent appraisals. If management determines significant adjustments should be made to the independent appraisals based on these evaluations, these measurements are considered Level 3 measurements.

Fair value measurements prepared internally are based on management's comparisons to sales of comparable assets, but include significant unobservable data and therefore are considered Level 3 measurements. The numerical range of unobservable inputs for these valuation assumptions is not meaningful to this presentation.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 18. Fair Value Measurements (Continued)

The following table summarizes the Company's approximate fair-value hierarchy for assets and liabilities measured on a recurring basis as of December 31:

		Fair Value Measurements at Reporting Date Using		
	Total	(Level 1)	(Level 2)	(Level 3)
<u>2014</u>				
Securities available-for-sale				
Collateralized				
mortgage obligations	\$ 46,433	\$ -	\$ 46,242	\$ 191
U.S. government-sponsored				
entities and agencies	3,280	-	3,280	-
States and political subdivisions	43,066	-	43,066	-
Mortgage-backed securities-residential	31,142	-	31,142	-
Asset-backed securities	3,279	-	3,279	-
Marketable equity securities	1,984	-	-	1,984
Total securities available-for-sale	129,184	-	127,009	2,175
Derivative assets	5	-	5	-
Total assets	\$ 129,189	\$ -	\$ 127,014	\$ 2,175
FHLB advances	-	-	-	-
Subordinated debentures and notes	1,031	-	1,031	-
Derivative liabilities	9	-	9	-
Total liabilities	\$ 1,040	\$ -	\$ 1,040	\$ -
<u>2013</u>				
Trading securities				
Collateralized mortgage obligations	\$ 315	\$ -	\$ -	\$ 315
Securities available-for-sale				
Collateralized				
mortgage obligations	44,202	-	34,245	9,957
U.S. government-sponsored				
entities and agencies	2,444	-	2,444	-
States and political subdivisions	43,371	-	43,371	-
Mortgage-backed securities-residential	34,224	-	34,224	-
Asset-backed securities	3,744	-	3,744	-
Total securities available-for-sale	127,985	-	118,028	9,957
Derivative assets	33	-	33	-
Total assets	\$ 128,333	\$ -	\$ 118,061	\$ 10,272
FHLB advances	2,157	-	2,157	-
Subordinated debentures and notes	1,031	-	1,031	-
Derivative liabilities	14	-	14	-
Total liabilities	\$ 3,202	\$ -	\$ 3,202	\$ -

Blackhawk Bancorp, Inc. and Subsidiary**Notes to Consolidated Financial Statements***(in thousands, except share and per share data)***Note 18. Fair Value Measurements (Continued)**

	Total	Fair Value Measurements at Reporting Date Using		
		(Level 1)	(Level 2)	(Level 3)
<u>2014</u>				
Impaired Loans	\$ 7,058	\$ -	\$ -	\$ 7,058
Foreclosed assets	886	-	-	886

2013

Impaired Loans	\$ 4,042	\$ -	\$ -	\$ 4,042
Foreclosed assets	1,830	-	-	1,830

The following table presents a reconciliation of assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Balance at January 1	\$ 10,272	\$ 18,000
Purchased assets	2,000	-
Transfers out of Level 3	(4,163)	-
Total realized and unrealized gains and (losses):		
Included in earnings	(265)	2,147
Included in other comprehensive income	-	(86)
Settlements	(5,669)	(9,789)
Balance at December 31	<u>\$ 2,175</u>	<u>\$ 10,272</u>

Securities transferred out of Level 3 valuation methods were private label collateralized mortgage obligations. Fair value on these securities were previously calculated using Level 3 valuation techniques because there was not an active market for these or similar securities due to the housing crisis that began in 2008. In 2014, market activity for similar securities had increased to the level that prices could be derived from an independent security pricing service using inputs from observable market data. The change in the reported fair values by using Level 2 valuation methods rather than Level 3 valuation methods was insignificant.

The impact of instrument specific credit risk on FHLB advances and subordinated debentures and notes was not material for the years ended December 31, 2014 and 2013.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 19. Shareholders Rights Plan

The Company's board of directors have approved and adopted a Shareholders' Rights Plan ("SRP"). An SRP is a mechanism used by many companies to better position their shareholders to realize the long-term value of their investment. In addition, SRPs better equip boards of directors to deal appropriately with parties whose interests in the Company may be different than those of the majority of current shareholders. An SRP achieves these purposes by making it financially unattractive for a person to acquire a large stake in a company or make a tender offer for its stock without first convincing its board of directors that such action is in the best interests of the company and its shareholders. The Company's SRP provides, in general, that if a person acquires a 25% or larger stake in the Company or makes a tender offer without the approval of the board of directors, all other shareholders will then become entitled to buy an additional amount of common stock for half market price.

Note 20. Preferred Stock

On March 13, 2009, the Company sold 10,000 shares of newly authorized Fixed Rate Cumulative Perpetual Preferred Stock, Series B, par value \$0.01 per share and liquidation value \$1,000 per share and also issued warrants to the U.S. Treasury to acquire an additional 500 shares of Fixed Rate Cumulative Perpetual Preferred Stock, series C, par value \$0.01 and liquidation value of \$1,000 per share for an aggregate purchase price of \$10,000,000 in cash. Immediately at closing, the holders exercised the warrants and the Company issued 500 shares of the Series C Preferred Stock.

The Series B Preferred Stock Qualifies as Tier 1 capital and pays cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series B Preferred Stock became redeemable by the Company after three years. The Series C Preferred Stock qualifies as Tier 1 capital and pays cumulative dividends at a rate of 9% per annum. The Series C Preferred Stock also became redeemable by the Company after three years. Prior to the end of three years, the Series B Preferred Stock and Series C Preferred Stock were redeemable by the Company only with proceeds from the sale of qualifying equity securities of the Company (a "Qualified Equity Offering"). Neither the Series B nor the Series C Preferred Stock is subject to any contractual restrictions on transfer, except that the holders or any of its transferees may not effect any transfer that, as a result of such transfer, would require the Company to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934.

Pursuant to the terms of the Preferred Stock agreements, the ability of the Company to declare or pay dividends or distributions on, or purchase, redeem or otherwise acquire for consideration, shares of its Common Stock will be subject to restrictions. The redemption, purchase or other acquisition of trust preferred securities of the Company or its affiliates also will be restricted. These restrictions terminated on the third anniversary of the date of issuance of the Preferred Stock.

On April 24, 2014, the Company redeemed all Series B and Series C preferred stock.

Blackhawk Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

(in thousands, except share and per share data)

Note 21. Interest Rate Risk Management-Derivative Instruments Not Designated As Hedging Instruments

Derivative Loan Commitments: Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. The Bank enters into commitments to fund residential mortgage loans at specified times in the future, with the intention that these loans will subsequently be sold in the secondary market. A mortgage loan commitment binds the Bank to lend funds to a potential borrower at a specified interest rate and within a specified period of time upon meeting any specified conditions, generally up to 60 days after inception of the rate lock.

Outstanding derivative loan commitments expose the Bank to the risk that the price of the loans arising from exercise of the loan commitment might decline from inception of the rate lock to funding of the loan due to increases in mortgage interest rates. If interest rates increase, the value of these loan commitments decreases. Conversely, if interest rates decrease, the value of these loan commitments increases. The notional amount of designated mortgage loan commitments was \$5,030 and \$3,630 at December 31, 2014 and 2013, respectively. The fair value of such commitments was a net asset of \$3 at December 31, 2014 and net liability of \$4 at December 31, 2013.

Forward Loan Sale Commitments: To protect against the price risk inherent in derivative loan commitments, the Bank utilizes primarily “mandatory delivery” forward loan sale commitments to mitigate the risk of potential decreases in the values of loans that would result from the exercise of the derivative loan commitments.

With a “mandatory delivery” contract, the Bank commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the Bank fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a “pair-off” fee, based on then-current market prices, to the investor to compensate the investor for the shortfall.

The Bank expects these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments. The notional amount of undesignated forward loan sale commitments was \$6,605 and \$3,544 at December 31, 2014 and 2013, respectively. The fair value of such commitments was a net liability of \$7 at December 31, 2014 and net asset of \$23 at December 31, 2013.

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Notes to Consolidated Financial Statements

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Note 22. Repurchase Agreement Valuation

From time to time, the Company enters into repurchase agreements with third-parties, whereby the Company advances funds to a third-party, who pledged collateral against the advances and agrees to repurchase such assets at a later date.

During 2014, the Company entered into a repurchase agreement, which was backed by the guaranteed portion of certain United States Department of Agriculture (USDA) loans, through a third-party (Third-Party). The Company has a long history with the Third-Party and has participated in similar arrangements since 2002. In the fourth quarter of 2014, the Third-Party reported that the USDA approved lender with whom the Third-Party, on behalf of its client, had entered into an agreement to purchase USDA guaranteed loans, committed fraud; the underlying loans and the USDA guarantees securing the repurchase agreements and the USDA assignment guarantee agreements were fraudulent. Prior to this discovery, the Company's interest in the repurchase agreement totaled approximately \$5,675.

In an effort to recoup losses, the Third-Party pursued various collection efforts that resulted in court approved agreements identifying and seizing assets (the Substitute Collateral) that are to be liquidated by a receiver or the Third-Party for the benefit of the Company and other investors. The Company has reviewed all of the Substitute Collateral, which consists of cash and cash equivalents, commercial real estate, and other assets, and has recorded a \$2,611 valuation allowance against the initial cost of the repurchase agreement. As of December 31, 2014, the Company's interest of this repurchase agreement, which is included in other assets in the consolidated balance sheets, totaled approximately \$3,064.

The value of the Company's interest in the repurchase agreement is subject to significant uncertainties with respect to the collection and liquidation of the Substitute Collateral. The Company is closely monitoring and supporting the collection efforts by the Third-Party. No assurance can be given to the ultimate value of the Company's interest in the repurchase agreement; however, the Company will continue to vigorously pursue all possible avenues to fully collect the initial recorded amount of the asset.